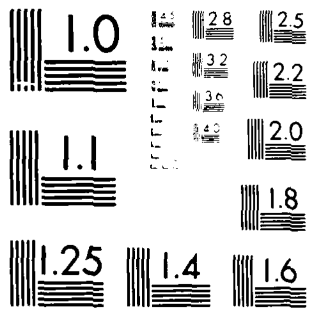
AD-A142 552 GUIDELINES FOR RESCUING LARGE FAILING FIRMS AND MUNICIPALITIES(U) GENERAL ACCOUNTING OFFICE WASHINGTON DC GENERAL GOVERNMENT DIV 29 MAR 84 GAO/GGD-84-34 1/1

UNCLASSIFIED F/G 5/3 NL

END
DATE FILMED
8-84
DTIC



MICROCOPY RESOLUTION TEST CHART
NATIONAL BUREAU OF STANDARDS 1963-A

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Guidelines For Rescuing Large Failing Firms And Municipalities

In the 1970s the government provided financial aid to three large firms and one municipality (Conrail, Lockheed, Chrysler, and New York City) to avert potential bankruptcies. From its own experience and from the recollections and experiences of over 100 others that have been involved in these programs, GAO developed guidelines on structuring, implementing, administering, and overseeing this type of program. GAO developed these guidelines so they would be readily available to assist others if similar programs are created in the future.

UNITED STATES GENERAL ACCOUNTING OFFICE

GAO/GGD-84-34
MARCH 29, 1984

Request for copies of GAO reports should be sent to:

U.S. General Accounting Office
Document Handling and Information
Services Facility
P.O. Box 6015
Gaithersburg, Md. 20760

Telephone (202) 275-6241

The first five copies of individual reports are free of charge. Additional copies of bound audit reports are $3.25 each. Additional copies of unbound report (i.e., letter reports) and most other publications are $1.00 each. There will be a 25% discount on all orders for 100 or more copies mailed to a single address. Sales orders must be prepaid on a cash, check, or money order basis. Check should be made out to the "Superintendent of Documents".

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-197380

To the President of the Senate and the
Speaker of the House of Representatives

This report describes the United States government's involvement and experience in four large-scale assistance programs (Conrail, Lockheed, New York City, and Chrysler) and suggests guidelines for the design, implementation, and administration of any future program. We anticipate that this guidelines document, which has been developed from the lessons learned from the government's experience with past programs, will be useful if the Congress should ever decide to aid another failing firm or municipality.

Copies of this report are being sent today to the Director, Office of Management and Budget; the heads of the departments or agencies directly involved; and other interested parties.

Charles A. Bowsher
Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

GUIDELINES FOR RESCUING LARGE FAILING FIRMS AND MUNICIPALITIES

D I G E S T

The federal government has no formal policy to deal with the potential failure of large firms or municipalities in which billions of dollars, thousands of jobs, or other vital national interests are at stake. While there are many federal programs to provide aid to large groups of individuals, certain industries, or those pursuing certain economic endeavors, such programs are not primarily designed to address the problems of a large failing firm or municipality.

The Congress has been highly selective in providing aid to individual firms and municipalities facing financial collapse. During the 1970s, the Congress created four separate financial assistance programs. These programs represent a middle ground between a formal policy for assisting firms or municipalities that meet established criteria and a strict policy of nonintervention.

NATURE OF GUIDANCE

The General Accounting Office (GAO) has been involved in all four previous programs. From its own experience and from the recollections and experiences of over 100 others that have been involved in these programs, GAO developed guidelines on structuring, implementing, administering, and overseeing this type of program. By pulling together in one place the lessons learned from earlier programs, GAO expects to assist those who might be involved in future programs.

By developing guidelines, GAO does not judge whether past or future programs are, or would be, an appropriate policy response to an impending failure of a large firm or municipality. Nor does GAO specify when the particular conditions facing a firm or municipality would warrant the government's providing aid.

The guidance provided in GAO's report does not yield simple operational rules telling what to do in all situations, because there are none. Instead the guidance consists of a framework of ideas about how to structure future programs and

what program requirements to include to achieve congressional goals and objectives while minimizing the risk of financial loss to the government. The history of past programs suggests that good ideas alone are not enough. In these programs, many very capable people worked very hard, and a similarly high level of expertise and effort will be necessary for future programs to succeed.

PAST PROGRAMS

The highly publicized Chrysler loan guarantee program is the most recent example of the government providing financial aid to a large, distressed firm or municipality. In 1980 and 1981 Chrysler received $1.2 billion in loan guarantees and was financially and operationally reorganized. (See p. 15.) Earlier examples include the creation of the Consolidated Rail Corporation (Conrail) and the credit assistance provided Lockheed and New York City.

In 1974, following the bankruptcy of the Penn Central and other Northeast railroads, Conrail was formed. It acquired the assets of the bankrupt railroads on April 1, 1976. It was provided with financial assistance in a variety of ways totaling about $7 billion. (See p. 8.)

Lockheed experienced financial difficulties in 1971 because of contractual problems with the Department of Defense and unanticipated costs associated with its reentry into the commercial aircraft business. It received $250 million in loan guarantees to overcome a relatively short term cash flow crisis. (See p. 10.)

New York City's rapid growth in municipal employment, a declining tax base, and some ill-advised financing and accounting practices eliminated its access to the municipal bond market in 1975. The City received direct short term federal loans of $2.3 billion to overcome cyclical cash flow problems for 3 years. In 1978, federal aid to New York City took the form of $1.65 billion in long term loan guarantees which formed the cornerstone of a new debt restructuring program. (See p. 12.)

In both the Conrail and Chrysler cases, GAO had direct program involvement as a result of the Comptroller General's membership on boards responsible for administering the programs. In the Lockheed and New York City cases, GAO performed its traditional oversight role.

DESIGNING INDIVIDUAL FINANCIAL ASSISTANCE PROGRAMS

In responding to these situations, GAO believes that it is essential that four conditions be met:

--the problem should be identified,

--the national interest should be clearly established,

--the goals and objectives associated with the response should be clear and nonconflicting, and

--the government's financial interests should be protected (see chapter 3).

PROBLEM IDENTIFICATION

When the federal government is approached by a troubled firm or municipality, it must identify the problem as accurately and quickly as possible. For example, a firm's problem may be largely its alone, or it may reflect broader industrywide or regional economic conditions. The problem may be more fundamental. Financial and economic analyses are crucial in identifying the nature of the problem. Furthermore, when the problem is brought to the government's attention, there is often only a short response time available to avert a crisis. Because of this, it would prove useful for the government to have a way to quickly assemble people from agencies with the appropriate expertise to evaluate the situation and propose a course of action.

DETERMINATION OF HOW THE NATIONAL INTEREST CAN BE SERVED

If the problems are largely specific to the firm or municipality, the Congress must decide whether the national interest will be served best through a legislative solution, or whether market forces and established legal procedures should proceed. In reaching this determination, the Congress should take into account all costs of a corporate or municipal collapse, not just those borne by the potential aid recipient and others benefiting from the potential aid. These costs would include those borne by the corporation's or municipality's constituents. The

Congress should also consider the disadvantages of providing aid, such as the costs borne by competitors who might be weakened if a failing firm were to receive aid.

For example, thoroughly analyzing the problem using sound financial and economic principles will help determine if

--potentially large economywide or regional consequences of a financial collapse cannot be controlled adequately through bankruptcy, or

--all costs borne by those affected are potentially larger under bankruptcy than under the legislative course of action.

The same sort of analysis should be used in assessing the financial situation to determine the amount of federal aid needed, changes that must be made to the firm's or municipality's existing contracts, and the amount of time necessary for recovery. A thorough understanding of the nature of the recipient's problems is crucial to the design of the rescue program.

CONGRESSIONAL GOALS AND OBJECTIVES

Once the problem has been identified and the decision made that the benefits of a rescue exceed those of bankruptcy, legislation must be written. It is important that congressional goals and objectives be clear, concise, and consistent.

The purpose of an individualized aid program might be

--to assure continuation of a product or service,

--to maintain existing levels of employment,

--to protect those with an economic stake in the recipient from disastrous losses, or

--to prevent a broader financial collapse.

It is important to choose clearly among potentially conflicting objectives. Without knowing the primary objective, it is difficult to decide what steps are appropriate and to judge whether a program has succeeded.

PROTECTING THE GOVERNMENT'S INTEREST

These programs pose an uncertain level of risk. Because of this it is important that the government's financial interest be protected. This can be achieved through:

1. Concessions From Others

The government should require others with a stake in the outcome to make concessions. The government should keep in mind, however, that the affected parties will cooperate only if the program offers a better alternative than bankruptcy or liquidation. The government should not expect creditors, for example, to make concessions that will cost them more than they expect to lose in a bankruptcy.

2. Controls Over Management

The government must have the authority to approve an aid recipient's financial and operating plans and new major contracts. To ensure that the government does not get overly involved in managing the recipient's operations, the government should establish criteria that limit the contracts and plans to be reviewed to those that are most important.

When the government rejects a proposed plan or contract because it is too risky, it should require the firm's or municipality's management to make changes and resubmit the proposal, but the government should not attempt to develop its own plans and impose them on management. To do so could leave the government responsible for the outcome.

3. Collateral

The government should require, where feasible, that the recipient maintain adequate collateral, and that all other lenders subordinate their claims on this collateral to the government's. In some cases, however, collateral may be unobtainable. When this occurs, as it probably would with a municipality, the government would have to rely on the other means of protecting the federal interest.

4. Compensation for Risk

The government should receive risk compensation in return for providing federal aid,

particularly if the program succeeds in restoring the recipient's financial health. Such compensation is not only desirable in its own right but can create incentives for the recipient to repay the financial assistance as rapidly as possible. Fees should be included, but they should not be set at a level representing full risk compensation. Fees at that level would cause too great a cash drain on the borrower. Therefore other forms of compensation should be obtained, such as equity participation. GAO believes that the use of warrants that allow the government to purchase shares of a recipient's stock at a specified price, as in the Chrysler case, is one form of equity participation that should be considered when aiding a firm. But in future programs, the decision on whether equity participation should be included as well as its form and amount should be made on a case-by-case basis.

AGENCY COMMENTS AND GAO EVALUATION

GAO sent a draft of this report for review to the Departments of Treasury, Transportation, and Commerce; the Office of Management and Budget (OMB); and the Board of Governors of the Federal Reserve System. GAO incorporated their comments into this report where appropriate. Treasury had no comments on the report's contents. Transportation said that the report draws very straightforward and reasonable conclusions. Commerce questioned the need for guidelines because it does not believe that federal intervention is often necessary or efficient, and suggested that these guidelines might encourage firms and municipalities to seek federal aid. GAO believes that the development of guidelines is warranted. If the Congress enacts federal rescue programs similar to those it has created in the past, the probability of success would be enhanced if these guidelines are followed in designing, administering, and overseeing the programs. GAO also believes that the requirements on recipients that the guidelines suggest might discourage rather than encourage firms and municipalities from seeking federal aid.

Both OMB and the Federal Reserve were concerned that the report made federal aid seem too desirable. They suggested changes that they believe would help GAO provide the balanced discussion they recognized GAO was trying to present. OMB suggested that federal aid to failing firms or

municipalities may be appropriate only if institutional impediments to a private reorganization or liquidation exist. GAO takes no position on when aid is appropriate. But GAO believes that the relevant criterion for the Congress to use in making the decision is a comparison of the anticipated costs, benefits, and consequences of providing and not providing aid. OMB also suggested a more thorough examination of the utility of bankruptcy laws in rescuing and reorganizing financially troubled firms. GAO recognizes that bankruptcy might sometimes be a viable option and discusses this alternative, but GAO also believes that a more in-depth discussion of bankruptcy than what the report provides would be outside the scope of this review. The Federal Reserve suggested that GAO's draft report minimized the disadvantages of providing federal aid. GAO agreed and added a discussion of this issue to its final report. The Federal Reserve also made numerous specific suggestions for revisions or clarifications which GAO considered and adopted as appropriate. (See chapter 4.)

Contents

ABBREVIATIONS

GAO	General Accounting Office
GNP	Gross National Product
MAC	Municipal Assistance Corporation
NERSA	Northeast Rail Service Act
RFC	Reconstruction Finance Corporation
USRA	United States Railway Association

CHAPTER 1

INTRODUCTION

During the 1970s, the Congress prov·ded one-time, large-scale, financial assistance to a few firms and, in one case, a municipality facing possible bankruptcy. Cash infusions were provided through direct or guaranteed loans to the Lockheed Aircraft Corporation, the Chrysler Corporation, and New York City. In the case of the Consolidated Rail Corporation (Conrail), the government took an ownership position. All these financial assistance programs were intended to be temporary, maintaining the borrowers' operations only until they could return to viability and repay the assistance, and/or return to credit markets without further government assistance.

These programs were created to avert potential bankruptcies and required specific legislation. Each program had a different justification, and each was structured somewhat differently from the others. Despite their being discrete programs, lessons can be learned from the federal government's experience with them. In this study, we examine the characteristics of these programs to provide guidance on their efficient design, implementation, and administration--should the Congress enact similar programs in the future.

A PERSPECTIVE ON CONTEXT

It is important to appreciate the special characteristics of these occasional responses to the impending failure of a large firm or municipality. These responses may appropriately be considered in the context of both federal credit policy and a very loosely defined U.S. industrial policy. But they are, on the one hand, a very special form of credit assistance and, on the other, a middle-of-the-road alternative between total nonintervention and a formally structured response to the problems currently being experienced by our basic industries and many of our cities.

Credit assistance policy and programs

The federal government has assisted individuals, firms, and municipalities in various economic sectors through direct and guaranteed loans and other means for over 100 years. Currently, the total amount loaned or guaranteed by the government exceeds $600 billion. This assistance has financed such diverse activities as housing, education, shipbuilding, and small business development. In most of these programs, the loans provided to borrowers are fairly small in their own right and very small in relation to total program portfolios. Therefore, it is possible, based on experience, to estimate default probabilities and, in turn, develop an actuarial basis for estimating losses. Furthermore, fees may be levied to cover anticipated losses when desired, and, at least for residential home mortgages, the collateral pledged to the government is generally sufficiently marketable at stable values to cover the government's exposure.

In contrast, the Lockheed, Chrysler, and New York City programs constitute a different use of credit assistance. First, since they are custom-tailored responses to the needs of a single borrower, they differ from programs that promote the desired activities of many in particular sectors of the economy. Second, because they are one-time programs no basis exists for estimating the probability of default based on a history of similar loans; therefore, there is no way of scientifically estimating the amount of expected losses. Unlike traditional government loan programs, these one-time programs do not have large loan portfolios and years of experience on which to base default probabilities and loss estimates. Thus, regardless of what steps are taken to minimize the federal government's exposure, one cannot be sure that such steps will be completely adequate in any specific situation.

Because risks are so high, fees levied by the government on these types of borrowers cannot at the same time adequately cover risk and leave enough cash in the firm or municipality to maximize the likelihood of program success. Furthermore, the value of collateral pledged in these programs is often uncertain. For example, the borrower's assets may be highly specialized and therefore not easily marketable at a value that reflects the value in their current use. In the case of a loan to a city, collateral has no substantive meaning because federal recourse to the city's equipment, building, and land would serve no useful purpose since vital services must continue to be provided. Because of the differences in policy objectives and risk characteristics between these programs and traditional uses of credit assistance, these programs must be structured and managed differently.

Alternative industrial policy responses

An informal federal policy of occasional responses to financial problems of individual firms and municipalities can be contrasted with the alternatives of bankruptcy and a formal assistance policy.

Bankruptcy

Many believe that bankruptcy is a cleansing and healing process for the economy that eliminates inefficient enterprises or makes them reorganize to improve their efficiency. It is argued that if the threat of bankruptcy were removed from our economic system, incentives for efficiency and good management would be reduced, thus lowering the growth potential of the economy and ightening the credit supply for companies that are profitable without federal assistance. But bankruptcy need not always mean the disappearance of a firm. Frequently, through bankruptcy, companies liquidate unprofitable operations, sell off some moneymaking operations to raise cash, and emerge restructured, but healthy.

These views are valid in most situations. However, many believe that our current bankruptcy system is not equipped to deal with the failure of a municipal or corporate giant. Because New York City had to continue to provide vital services to its inhabitants, its bankruptcy may have meant, among other things, a federally run city and large federal outlays to preserve those services. Practically speaking, it is worth questioning whether a bankruptcy court is more capable of managing a large city than its elected officials and their staffs, albeit under close federal or state supervision. Most people we interviewed believe that if Chrysler had chosen or involuntarily entered bankruptcy, it almost certainly would have been liquidated because the uncertainty surrounding Chrysler's ability to warrant service and performance would have limited its ability to sell new cars.

Bankruptcy may be an inappropriate framework for reorganizing a large company without imposing enormous penalties on dependent constituents. No major U.S. corporation has yet gone through a liquidation proceeding of the size that Chrysler would have experienced, with the possible exception of Penn Central. But the evidence from smaller liquidations suggests that settling claims against Chrysler would have taken many years. Some of those with a stake in the corporation probably could not have afforded to wait and would have been forced into bankruptcy themselves because their interests coincided so closely with those of the company. At least part of the justification for past assistance programs has been that through what is known as a "workout," an orderly, faster response occurred than would have under a bankruptcy proceeding.

The possibility remains that if in the past the government had maintained a hands-off position that was understood by everyone, workouts might have occurred without federal involvement outside of bankruptcy. No one can know for sure, but by providing assistance when it did, the government avoided the risks associated with finding out.

Formal assistance policy

During the Great Depression, the Government addressed the problems of widespread business failures, unemployment, and municipal fiscal crises by creating in 1932 the Reconstruction Finance Corporation (RFC)--a powerful agency with authority to borrow funds from the Treasury and make loans to banks and other financial institutions and, later, to firms. During its existence, the RFC disbursed more than $40 billion ($100 to $200 billion in current dollars) and was committed to disburse billions more under various guarantee arrangements. The RFC aided many major economic sectors, including financial institutions, railroads, agriculture, commercial and industrial businesses, construction, public agencies, and national defense industries. The RFC also pioneered the use of long-term mortgage instruments. In these ways, it played a major macroeconomic role in stopping deflation and stabilizing the economy.

The RFC's loan authority was terminated in 1953 and the Corporation was terminated in 1957. Reasons for its abolition included

--changes in the Nation's economic condition, with concerns about inflation replacing concerns about depression;

--transfer of many of its functions to other federal agencies;

--the increasing popularity of the argument that private capital markets were more capable of efficiently allocating capital than the RFC; and

--questions raised regarding political favoritism and corruption.

According to a few of the people we interviewed and others who have written on this topic, an explicit policy of providing capital for some of the Nation's struggling firms and cities is again necessary. They believe that in light of current economic conditions there is a need to improve the competitiveness of our basic industries and to rebuild the public facilities of older cities. Proponents of this view often recommend that the Congress create a new agency similar to the RFC to carry out this mission. In at least one proposal, the new RFC would offer capital on the condition that other affected parties--workers, creditors, management, etc.--make changes that improve the financial position and cost structure of eligible industries. These improvements would need to be extensive enough to create a reasonable chance that our basic industries will become more competitive and financially sound. In addition, a new RFC might absorb existing agencies that provide credit assistance and other subsidies to firms and municipalities.

The majority of others to whom we spoke do not believe that a new RFC is desirable either in its own right or as an alternative to deal with the impending failure of a large firm or municipality. The view is expressed that an RFC-type program, like any other program intended to deal with entire populations of diverse program beneficiaries, would have to contain eligibility standards for loan application, acceptance, and approval. An almost universally held view of those who have managed the large assistance programs of the 1970s is that it is not possible to write an all-encompassing set of eligibility standards that adequately considers the diverse situations and problems faced by large failing firms and municipalities. And, regardless of how eligibility standards are written for broader populations, once the ground rules for receiving assistance are made formal, companies and municipalities with varying financial needs will figure out ways to meet those standards. Therefore, the concern is that once the assistance criteria are known, the new RFC will become just another source of government assistance--not totally unlike that provided by many existing federal programs.

Several people we interviewed suggested additional potential problems with establishing an RFC-type agency. They suggested that finding the right people to staff such an agency would be difficult if salaries were limited or if the work did not generally involve the challenge of complex workouts of the financial problems of large distressed firms and municipalities. Reviewing routine requests for assistance might not be interesting or challenging enough to attract the staff that would be needed when more complex cases arose. They also suggested that a lack of appropriate skills would mean hiring additional full-time staff or experts to manage the more complex situations. Thus, the bureaucracy conceivably could grow with each assistance request and/or approval. Also, the view was expressed that, once established, an agency might tend to view its mission as accomplishing something and seek applicants. On the other hand, if there were periods in which there were few requests for aid, it would be inefficient to maintain a staff with little to do. In addition, the pressures to allocate aid on political rather than economic grounds might be very strong.

We do not take a position on whether a formal, explicit industrial policy that might call for establishing a new RFC is desirable. To do so would require an evaluation of the entire scope of activities with which such an agency might be involved; such an evaluation was beyond the scope of our review. We do observe, however, that the Congress has been highly selective and infrequent in providing aid to individual firms and municipalities facing financial collapse. As long as this continues to be the case, an RFC-type agency would probably not be an efficient or effective way to provide such aid to large failing firms or municipalities.

OBJECTIVE, SCOPE, AND METHODOLOGY

This report provides guidance to the Congress on the design, oversight, and administration of large-scale, one-time, individual financial assistance programs. The importance of these programs, the controversy associated with them, and the differences in policy objectives and risk characteristics among them, as well as between them and traditional credit assistance programs, suggest that guidance is needed if the past approach to these situations is used again. The guidelines we developed provide congressional decisionmakers with more efficient, systematic, and consistent standards to design future financial assistance programs, thereby enhancing their probability of success.

In concluding that such guidelines are needed, we are not judging whether past and future programs are, or will be, an appropriate policy response to the impending bankruptcy of a large firm or municipality.

Our involvement with the Conrail, Lockheed, Chrysler, and New York City situations gave us a base of knowledge on which to build. In this review, we studied these programs in great depth

to learn how they were structured, what they were intended to accomplish, and how the specific program elements affected the program results. We did not evaluate the effectiveness or efficiency of these programs nor judge their success.

Other programs that might seem similar, such as Amtrak and the financial assistance programs provided by the Synthetic Fuels Corporation, were not studied extensively. Nevertheless, we did draw some ideas from these and other programs when relevant. Amtrak differs from the others in that the government's financial assistance to ensure the preservation of passenger rail service was not (except initially) intended to be temporary. Assistance to promote synthetic fuel development differs both because many firms could receive aid and, more importantly, because the intent of that assistance is to promote a new product (a venture capital situation) rather than to preserve existing products and services (a workout situation).

In studying past programs, we reviewed their legislative histories and published information about them, including our previous reports. We supplemented that information by interviewing congressional staffers and former members of Congress who were responsible for developing each program's authorizing legislation. These interviews and legislative histories yielded valuable information on congressional objectives, the process by which each assistance package was structured and its rationale, and alternative legislative provisions that were considered but not enacted.

We conducted extensive interviews with more than 100 people who are familiar with these programs to obtain a wide range of perspectives on the effects of various provisions on the operation of the programs and the key factors that should be considered in designing future programs. Our review, which was conducted between June 1982 and March 1983, was performed in part at the offices of Lockheed Corporation (formerly Lockheed Aircraft Corporation), Burbank, California; Chrysler Corporation, Highland Park, Michigan; Consolidated Rail Corporation (Conrail), Philadelphia, Pennsylvania; and New York City, New York. At these sites and elsewhere, we talked with current and former representatives of these organizations and representatives of other groups who participated in and stood to gain from the programs, such as workers and creditors. In Washington, D.C., and other locations we met with current and former government officials responsible for administering the programs, such as those from the Departments of Treasury and Transportation and the Federal Reserve System, and others who either played important roles in the programs or have studied them. Though opinions differed on the issues that the interviewees were asked to address, these differences did not generally correspond to differences in the interviewees' roles in past programs.

We believe two considerations are of overriding importance in designing assistance programs:

--assistance should focus on accomplishing the congressional goals and objectives of the program; and

--as much as possible, the government's financial interest should be protected.

Research suggests that, after incorporating considerations involving congressional intent, reliance on the principles and practices followed by commercial lenders is not only possible but crucial in accomplishing both aims. To develop a thorough understanding of commercial lending principles and practices, we reviewed the banking and finance literature. This literature provides conventionally accepted measures of risk and analytical means to evaluate risk, and helped us in determining the government's data requirements for assessing the risks of providing aid.

We also interviewed loan officers, specialists in reorganizing troubled firms, investment bankers, and other important members of the financial community, primarily in New York City, to learn how they apply lending principles in making decisions about originating, structuring, and terminating loan agreements. We were particularly interested in commercial practices that are most applicable to the government's role as a lender to financially distressed firms and municipalities. The key issues we explored included how to control risk and how to determine the relative benefits and costs of defaults and workouts.

THE NATURE OF THE GUIDANCE

The guidance we provide does not take the form of hard and fast rules. Instead, it provides a way of thinking about the crucial ingredients needed in designing, implementing, and administering these programs. At its most fundamental level, our guidance is based on designing, administering, and overseeing each program to exploit incentives and motivations for protecting the self-interest of all parties involved.

We also provide guidance on the type of information that should be sought and the types of analyses that should be performed in structuring the program. This guidance will help in comparing the numerous and sometimes very severe trade-offs among the competing objectives of restoring a firm or municipality to self-sufficiency, protecting the government's financial interest, and achieving more broadly oriented congressional goals.

Our conclusions about how commercial lending principles and practices can be applied to government programs and how different structural elements of past programs affect their outcomes form the basis for the guidelines, their justification, and the specific requirements needed to make the programs consistent with the guidelines.

CHAPTER 2

HISTORY OF ONE-TIME INDIVIDUAL FINANCIAL ASSISTANCE PROGRAMS

While past federal government responses to financially distressed large firms and municipalities have shared some common elements, they have also differed in many ways, such as in the type and amount of aid provided, the extent to which beneficiaries of the program were asked to make financial contributions, the extent and method of risk exposure coverage, and the method by which the government oversaw the program.[1] In this chapter, we discuss the assistance programs involving the Consolidated Rail Corporation, the Lockheed Aircraft Corporation, New York City, and the Chrysler Corporation. The discussion of the differences and similarities in circumstances faced by these aid recipients and the way events affected the government's response lays a very important foundation for the development of the guidance contained in the remainder of this report.

CONRAIL

Extensive federal government involvement with the railroad industry was prompted by Penn Central Corporation's bankruptcy in 1970. At the time, Penn Central was the largest transportation company in the Nation. It was formed in 1968 when the Pennsylvania and the New York Central railroads merged. Penn Central experienced financial difficulties from its beginning. A combination of increasing competition from the trucking industry, rising labor costs, regulated rate increases that lagged cost increases, and an inability to truly merge the two railroads caused Penn Central to lose $5.2 million and $56.3 million in 1968 and 1969. The losses for the railroad division alone were even worse but were partially offset by profits from nonrailroad divisions.

Penn Central's rail situation became critical in the winter of 1969-70. Operating expenses soared and rail passenger service losses increased to $375,000 per day. The first quarter loss alone was $102 million. These losses forced Penn Central to request emergency government assistance in May 1970. Two assistance plans were initially discussed, an interim $200 million federal loan guarantee from the Department of Defense and a plan of $750 million in long-term guaranteed loans to the railroad industry from the Department of Transportation, of which, we were told, $300 million would have been immediately available to Penn Central.

---

[1]A summary of the provisions in the various aid program acts is contained in a table at the end of this chapter.

However, neither assistance program was implemented as unexpectedly strong opposition surfaced. The idea of using taxpayers' money to bail out a private corporation and its creditors was opposed in principle, and the use of Department of Defense funds for this purpose was questioned as being an inappropriate use of Defense Production Acts funds. In June 1970, Penn Central, unable to obtain financing from the private sector or the federal government, filed for bankruptcy under section 77 of the Bankruptcy Act. Under this section of the act, railroad companies are not allowed to go out of business. It is assumed that the company will be reorganized and continue to provide rail service. However, in Penn Central's case, the problems were so bad that operating income could not cover operating expenses, meaning that the railroad incurred more losses by operating than if it had shut down.

In January 1974, the Congress passed the Regional Rail Reorganization Act (the 3R Act) to preserve rail service. With this legislation, the federal government began a comprehensive attempt to rescue and reorganize Northeast and Midwest railroads. The purpose of the 3R Act was to salvage the operations of eight bankrupt or near bankrupt railroads and replace them with a new rail service system. The act was passed to (1) alleviate unemployment problems and the associated welfare payments, (2) reduce tax losses resulting from the bankruptcies, (3) assure that rail services would be maintained in the Northeast and Midwest, and (4) mitigate the adverse effects of the bankruptcies on the commercial paper market. A combined package of $2.1 billion in loans, loan guarantees, and grants was pledged by the federal government as the initial phase of the government's support of Conrail. Subsequent government support has brought this total to about $7 billion.

The United States Railway Association (USRA) and the Consolidated Rail Corporation were both formed by the 3R Act. USRA is an incorporated nonprofit association--a government corporation--created to plan and finance the acquisition, rehabilitation, and modernization of the new system. Conrail was created as a private corporation with the right to acquire rail properties from the bankrupt railroads and operate the consolidated system. Conrail initially (April 1, 1976) obtained about 19,200 route miles over which to operate in 17 states and the District of Columbia. However, this mileage was reduced over time to its current level of about 16,200 miles. A "Final System Plan" was prepared, designating how the rail properties of the bankrupt railroads would be disposed of, estimating future earnings of Conrail, and recommending the capital structure of the new company and the value of the rail properties transferred to Conrail. With the acceptance of the "Final System Plan", the remaining major issue was establishing the value of the railroads acquired by USRA. A special court was established for this purpose. Settlement of the estates of the bankrupt railroads eventually cost about $2.8 billion.

By 1977, Conrail was well into a program of renovation. However, in 1978 Conrail ran into difficulties, losing over $430 million. Losses forced Conrail to request more than $700 million for fiscal year 1979. In 1979 and 1980, there were further losses of $221 million and $244 million. These losses were attributed to higher than average labor costs, frequent equipment breakdowns, and inflationary increases in operating costs.

In a 1981 report, USRA concluded that Conrail could not become self-sustaining in its present structure and within the authorized spending limits. A combination of a shrinking Northeast industrial base, declining rail traffic, changing economic needs, increasing costs of labor protection, and federal policies were preventing Conrail from becoming a viable long-term rail system. To achieve viability, labor costs needed to be reduced, commuter passenger services eliminated, and labor protection requirements reduced. The Staggers Act of 1980 and the Northeast Rail Service Act of 1981 (NERSA) addressed these problems. The Staggers Act granted relief from certain regulations. NERSA provided for relief from passenger service obligations, wage concession goals from railroad employees of $200 million a year for 3 years, reductions in benefits to displaced workers, and a commitment to sell the government's interests in Conrail. The act also redefined the membership of the USRA Board to be the Secretary of Transportation, the Chairman of the Interstate Commerce Commission, the Comptroller General of the United States, the Chairman of the Board of Conrail, and the USRA Board Chairman.

Conrail took advantage of the relief provided by the acts. In 1982 and 1983, the company turned a profit. Under NERSA, the United States Railway Association was required to decide by June 1, 1983, whether Conrail would be a profitable carrier. On June 1, 1983, the USRA Board announced its affirmative finding in this regard. This finding, combined with the Board's affirmative finding (another NERSA requirement) that Conrail was profitable between June 1 and October 31, 1983, established that Conrail could be sold only as a single property before June 1, 1984. After that date, if the Secretary of Transportation determines that no acceptable offers have been received, and if the USRA board approves the Secretary's determination, the Secretary may sell Conrail's assets piecemeal, if the sale meets other requirements.

LOCKHEED

The financial assistance program for Lockheed set an important precedent. The 1971 legislation providing assistance to Lockheed was very controversial, passing by only the slimmest of margins in both the House and the Senate. However, by approving this legislation, the government indicated that it was indeed willing, in certain circumstances, to provide financial assistance to a failing corporation. Thus, proponents of subsequent aid programs, in particular those to assist the

Chrysler Corporation and New York City, had a fundamental roadblock removed.

In 1971, the Lockheed Aircraft Corporation requested federal assistance to overcome the effects of several events that created a severe liquidity crisis. The chain of events began in the mid-1960s, when Lockheed decided to reenter the commercial aircraft market to exploit what was then perceived as a strong demand for wide-bodied jet aircraft. However, Lockheed underestimated the cost of reentry. Because of the enormous capital acquisition and research and development costs required to produce its L-1011 "Tristar," by the late 1960s the company was considerably overextended: it had insufficient financial resources to maintain current operations. A series of disputes between Lockheed and the Department of Defense on several military contracts aggravated the problem; the unfavorable legal settlements of these disputes cost the company $484 million over several years. As a result of the combined effects of heavy expenditures on its L-1011 program and these legal settlements, the company experienced a net loss of $86.3 million in 1970.

However, it is likely that the firm could have managed without assistance, if not for another major setback. In February 1971, Rolls Royce, a British firm that manufactured the RB211 engine for the Tristar, announced it was going into receivership. In the midst of these developments, Lockheed's ongoing negotiations with several banks for a new $600 million financing package were broken off, and the company was forced to delay the Tristar program while efforts were made to resolve Rolls Royce's problem.

Lockheed approached the government for assistance in overcoming what it described as a liquidity problem. Unless the airplane was delivered, the company would sustain a great loss on this investment. Management believed that without federal assistance, the L-1011 program would not be completed, and Lockheed would enter bankruptcy. Furthermore, the British government would not assure production of the RB211 engine unless it had assurances that the L-1011 would be produced.

To meet Lockheed's need and to respond to the British government's requirements, the Congress passed the Emergency Loan Guarantee Act in August 1971. Although the act was worded to allow emergency loan guarantees to any major business enterprise, the intent was clearly to provide up to $250 million in loan guarantees to Lockheed. Three major arguments were advanced for passing the legislation. Perhaps the most important was the economic implications of bankruptcy. Many believed that providing assistance would save jobs, not only at Lockheed, but also at Lockheed's suppliers throughout the country. According to rough estimates, a bankruptcy would have meant a loss of 60,000 jobs and a potential GNP loss of $120 million to $475 million, with $75 million to $300 million of this in California alone, just as the economy was recovering from the 1969-70 recession.

The second major argument involved the effect of a bankruptcy on national defense. Since Lockheed was a major defense contractor, much concern was voiced about how easily or effectively other manufacturers or even a reorganized Lockheed could meet the government's military needs.

The third argument concerned how a bankruptcy would affect competition in the aerospace industry. The loss of Lockheed would leave only Boeing and McDonnell Douglas as competitors in the aerospace industry for commercial jets. Furthermore, competition among military aircraft producers would also be reduced.

To administer the loan guarantee program, the government established a three-person board consisting of the Secretary of the Treasury as Chairman, the Chairman of the Board of Governors of the Federal Reserve System, and the Chairman of the Securities and Exchange Commission. Before a loan guarantee could be made, this board had to determine that (1) the loan was needed to avoid adverse economic effects; (2) credit was not available elsewhere; and (3) the prospective earning power of the borrower, together with the security pledged, furnished reasonable assurance of repayment of the loan and afforded reasonable protection to the government.

The government's financial interests were protected in many ways. The Emergency Loan Guarantee Act directed the board to make every effort to assure that the amount of the loan guarantee was covered by sufficient collateral (assets pledged to secure the guaranteed loans). In addition, the act prohibited the declaration of dividends on common stock and restricted payments on other indebtedness to a lender whose loan had been guaranteed. The act also gave the board the power to make management changes, disapprove asset sales, and inspect all books and accounts in carrying out its duties. The General Accounting Office was authorized to audit the borrower and report the results to the Congress and the board.

With the assurance of $250 million in loan guarantees, Lockheed was able to negotiate a new aid package totalling $750 million. In addition to the loan guarantees, the package consisted of a $400 million restructured credit agreement with its banks and an additional $100 million in airline customer prepayments. This assistance, along with later debt restructurings, allowed Lockheed to complete the L-1011 program. The government's guarantee, which was scheduled to expire on December 31, 1977, was voluntarily terminated by mutual agreement on October 14, 1977. Lockheed replaced the government assistance with a revolving credit agreement providing up to $100 million.

NEW YORK CITY

Private corporations were not the only recipients of large, discrete financial assistance packages. New York City, in 1975 and again in 1978, received aid in two separate programs.

The causes of New York City's financial problems can be traced back to the early 1960s. That decade was characterized by a continuous growth in social programs and public employment, extensive liberalization of city employee pension plans and other fringe benefits, and the city's continuation of an unusually high level of support for hospital care and higher education. During the 1960s, this spending was financed by a strong economy and increases in state and federal aid. However, in the 1970s, the local economy faltered. While spending continued to increase, it was not matched by increased state or federal aid or higher taxes. The result was major deficits. To meet these deficits, the city relied heavily on borrowing. In the 6-year period through fiscal year 1975, short-term debt tripled and long-term debt increased more than 50 percent. By the fall of 1974, New York City was having difficulty in selling its notes, and by April of 1975 it could no longer borrow at any price.

Faced with the prospect and implications of a city default, the state began to take remedial action. It arranged to advance $800 million to the city to meet its needs through June 30, 1975. In addition, in June 1975, the state formed the Municipal Assistance Corporation (MAC) to assist the city in providing essential services and to instill confidence in the debt obligations of the city. MAC was authorized to sell bonds and notes. The immediate plan was to replace much of the city's short-term debt with long-term MAC obligations to buy time until more fundamental reforms could be made. These bonds were secured by state taxes imposed on retail sales within the city and state stock transfer taxes. The MAC legislation also required that the city develop an accounting system that would meet state requirements and that the city's budget be balanced under the revised system of accounting by 1977, except for capital items. In September 1975, the state took further action by enacting the Financial Emergency Act for New York City which created the Emergency Financial Control Board. This legislation essentially put the city's fiscal affairs under the direct oversight of the Control Board and directed the city to prepare a 3-year financial plan to be approved by this board.

Despite these state actions, further assistance was necessary. The Administration and the Congress agreed to offer assistance in part because the state had already taken some action. Another reason the federal government acted was because a default or bankruptcy of a municipality the size of New York City would have had uncertain national and international implications, in addition to the direct effects on both the city and the state. The entire New York area could have experienced increased unemployment, cuts in services, and bankruptcies. The federal government would probably have had to finance increased welfare, unemployment payments, and other forms of direct assistance and would have experienced tax revenue losses. There might have been major effects on municipal bond markets and huge losses for 200 to 300 banks holding New York City securities. Finally, there might have been significant effects on world

monetary stability and confidence in the United States' financial systems. As much as anything else, the uncertainty about the ramifications of a bankruptcy caused the federal government to act.

The Congress passed the New York City Seasonal Financing Act of 1975, providing up to $2.3 billion in seasonal financing. The intent of the act was to provide short-term financing to overcome cyclical shortfalls between continuous city expenditures and periodic tax collections. The aid came from the Department of the Treasury in the form of direct loans with maturities not to exceed 1 year. These loans could be made under such terms and conditions as deemed appropriate by the Secretary of the Treasury, only if there was a reasonable prospect of repayment. Each loan, which was to mature by the last day of the city's fiscal year in which it was made, was repaid as due. As part of the credit agreement, the Secretary required the city to develop an accounting system, which would be audited after June 30, 1978, that met the requirements of the state. The authority to make loans to the city terminated on June 30, 1978.

However, it was judged by the city, the Financial Control Board, the Municipal Assistance Corporation, and others that seasonal financing was not an adequate solution to the city's financial problems and that longer term assistance was needed. The new assistance came with the enactment of the New York City Loan Guarantee Act of 1978, which provided for up to $1.65 billion in loan guarantees. These guarantees could last as long as 15 years and would be available only for bonds sold to city or state pension funds. The guarantees formed an important part of a $4.5 billion financing package consisting of funds from both public and private sources.

In addition to this shift to a long-term financing approach, the new legislation was much more specific than the 1975 act. The Secretary of the Treasury was again solely responsible for oversight and could issue guarantees only if (1) there was a reasonable prospect of repayment of the city bonds to be guaranteed, (2) the city could not obtain credit elsewhere, and (3) the interest rates were reasonable. In addition, state financial support and oversight (by the Financial Control Board) and independent audits of accounts would continue. We were, as before, authorized to make such audits as believed necessary. Finally, the city was required to make progress toward, and attain by 1982, a budget that was balanced in accordance with generally accepted accounting principles, a step that had already been taken by the Financial Control Board.

With the issuance of the federally guaranteed city bonds, the city has been able to make progress toward its goals. The $1.65 billion in guaranteed bonds were sold to city and state pension funds. The city, as of December 31, 1983, had redeemed about $500 million of these guaranteed bonds. The budget has

been balanced according to generally accepted accounting principles. The city was able to reenter the credit markets on a small scale in fiscal years 1981 and 1982, and on a larger scale in fiscal year 1983.

CHRYSLER

In 1979, Chrysler approached the Congress and the administration for aid. Like the aid to Lockheed, assistance came in the form of loan guarantees. However, in many other respects the Chrysler program differed substantially from the Lockheed program. The assistance was much greater and the program was more complicated, resulting in a complete restructuring of debt and requiring major concessions from parties with a stake in Chrysler's future. In this process, the federal government played a major role.

Chrysler's request for federal assistance was the result of growing financial problems during the 1970s. Reasons most often cited for these problems included higher per unit production costs than its larger competitors, unsuccessful efforts to become a multinational manufacturer, questionable marketing decisions, and the costs of complying with federal regulations. Although several of these problems had existed since the 1950s, the events that directly led to Chrysler's appeal for assistance in 1979 began earlier in the decade.

The 1970s brought two changes that had a major effect on the automobile industry: the fluctuating price and availability of gasoline and increasing federal regulation of the auto industry. Both factors contributed significantly to Chrysler's problems. The rapidly changing gasoline situation meant not only increased expenditures for "down-sizing" efforts but also great uncertainty as to what car models would be demanded. Chrysler misjudged the market with many of its new car models and sales suffered.

At the same time, federal safety, pollution, and fuel efficiency regulations were becoming increasingly stringent. These regulations required that enormous resources be spent for both research and development and production. Chrysler was particularly burdened because it could not spread these costs over production runs as large as those of General Motors or Ford. These factors contributed to a severe cash flow problem and losses in 1978 and 1979 of \$218 million and \$1,126 million.

After several months of deliberation, the Congress authorized assistance for Chrysler. The major reasons advanced for passing this legislation were similar to those in the Lockheed case. The overwhelming reason was to avoid the regional and national effects a bankruptcy would have on unemployment and output. In 1979, Chrysler was the 17th largest (10th in 1978) manufacturing corporation in the country, employing 134,000 workers concentrated in the Detroit area, which already had a

high rate of unemployment. Also, as with the Lockheed case, there was concern about the effect of losing a major manufacturer in the industry; without Chrysler, only Ford and General Motors would remain as major domestic auto producers. Similarly, there was concern about losing Chrysler as a defense contractor, since it was the sole producer of the M-1 tank. However, unlike Lockheed, there was a fourth major concern--the effect of bankruptcy on market penetration by foreign competitors and the U.S. balance of payments.

The Chrysler Loan Guarantee Act, signed in January 1980, provided for up to $1.5 billion in loan guarantees. A five-person board, with three voting members and two nonvoting members, was established to administer the program. The voting members of the board were the Secretary of the Treasury as Chairman, the Chairman of the Board of Governors of the Federal Reserve System, and the Comptroller General of the United States. The non-voting members were the Secretaries of Labor and Transportation. Before granting any guarantee, the most important determinations required of the board were that (1) credit was not available elsewhere, (2) a serious adverse effect on the economy would occur without the loan, (3) the firm would remain a going concern beyond 1983 without further assistance, and (4) there was a reasonable prospect of repayment by 1990.

The basic issue was whether Chrysler was an economically viable operation. This contrasts sharply with the case of Lockheed, for which the problem was perceived as basically a short-term cash flow crisis (lack of liquidity). In addition, in the Chrysler program nearly all beneficiaries of the government assistance were required to make significant concessions. The government's aid was to be matched by nonfederal assistance, and concessions were required from U.S. and foreign banks, governments, and creditors; stockholders, suppliers, and dealers; and union and nonunion employees. Specific amounts of nonfederally guaranteed assistance in each of these categories were suggested by the act, although the individual elements of concessions were adjusted by the board. Finally, the conditions imposed for protecting the government's interest were very restrictive. Like the act authorizing aid for Lockheed, the Chrysler legislation called for collateral, restrictions on dividends, inspection of books, and GAO audits. However, in addition to a much tighter Agreement to Guarantee between the government and Chrysler, there were conditions requiring the board's approval of asset sales over $5 million and any contract of $10 million or more. The board also was required to approve Chrysler's operating and financing plans and was authorized to obtain additional financial compensation for the risk the government was assuming. Under the terms of the Agreement to Guarantee, Chrysler issued the government warrants to buy 14.4 million shares of Chrysler stock at 13 dollars per share. In 1983, after the guaranteed loans were repaid, the government invited underwriters who qualified to make a public distribution and Chrysler to bid for these warrants. The government sold these warrants to Chrysler, the highest bidder, in September 1983 for $311 million.

As a result of the Chrysler program, the company was financially and operationally reorganized without going through a bankruptcy. The firm is much smaller and more efficient than it was 3 years ago. The restructuring took place fairly quickly with less interruption of the firm's operations than would have occurred in a bankruptcy. Nonetheless, Chrysler did experience significant operational interruptions, laid off many employees, revised operating and marketing strategies, and required personal sacrifices from its employees.

Chrysler used $1.2 billion of the $1.5 billion guarantee authority. This occurred through three separate financings, two in 1980 and one in 1981. On June 15, 1983, the company redeemed $400 million of the government guaranteed notes, and the remaining $800 million in notes were redeemed 2 months later. From a disastrous loss of $1.7 billion in 1980, the company showed profits in 1982. The company's chronic cash flow problem has been eased and a dramatic lowering of its break-even point has occurred.

CONCLUSIONS

A review of the history of the four situations in which the federal government intervened in the affairs of a large failing firm or municipality indicates an evolution in thinking about how to approach, as well as design and implement, these programs. For example, in the early 1970s, Penn Central was "allowed" to go bankrupt. Later the federal government intervened, forming Conrail. However, this action involved very little in the way of constituent sacrifice and commercial lending principles were not applied to resolve Conrail's financial and operational problems. For all intents and purposes, the government took a highly subordinated ownership position in Conrail. On the other hand, the 1979 Chrysler program has frequently been characterized as the most sophisticated in terms of how commercial lending principles were embodied in the program's structure. For example, the government insisted on a priority claim to assets in the event of default, numerous financial concessions from virtually all those associated with the firm, and numerous restrictions on the decisionmaking powers of the company's management. The Lockheed and New York City programs fall in between these two extremes, with the 1975 New York City program relying more on commercial principles than the earlier Lockheed program.

Each new program incorporated lessons from previous ones into its design, implementation, or administration. However, some of the increasing emphasis on taking a commercial approach to these situations was based on the specifics of each case and the largely coincidental ordering of the programs during the 1970s (first a railroad company, then a major defense contractor, then a municipality, then an automobile company).

In the Penn Central/Conrail case, for example, bankruptcy law was capable of restructuring the situation. Though it is

arguable whether bankruptcy was the best course of action to follow, it is clear that because of its availability, a commercial workout outside of the courts was not essential to keep the railroad running. To some extent, the Chrysler program relied so heavily on commercial principles, and the legislation mandated very specific requirements on both the corporation and the board, because at the time the company sought government assistance it had developed no plan of its own for restructuring its operations. Because of this, and because by the time the government was approached by Chrysler the company was on the brink of collapse, the legislation that the Congress wrote imposed the elements of constituent sacrifice that would generate sufficient cash to carry Chrysler through a financial and operational restructuring. Furthermore, many people believed that bankruptcy was not an acceptable solution to Chrysler's problems. Therefore, because of concerns about whether the company could independently restructure its operations, the elements of the rescue package had to be made explicit in a different forum.

In both the New York City and Lockheed cases, major self-help components of the rescue plan were in place before the request for federal aid. Because these commitments were in place, there was little need for the Congress to legislate them. Furthermore, in New York City's case, the major responsibility for structuring and overseeing the program had to rest with New York State. Also, Lockheed's problems were less severe than Chrysler's; accordingly, one might argue that less drastic measures were necessary.

Thus, the evolution in reliance on commercial lending principles that took place was related to the lessons learned from previous experience, the unique circumstances faced by each party, and when these circumstances occurred. Clearly, commercial principles could have been relied on more heavily in structuring a program to consolidate the bankrupt railroads into Conrail in 1974. Lockheed might have overcome its liquidity crisis more rapidly had other concessions been sought from those with a financial interest in the company. In the New York City program, other groups might also have participated financially and accelerated the city's achievement of a balanced budget and self-financing in private capital markets.

To some extent, all of these lessons learned were brought to bear in the Chrysler situation. We anticipate that should there be another such program, the benefit of previous experience will result in an even more financially rigorous program if the circumstances warrant it. But because each situation will be unique, the designers of future programs may not always be able to incorporate all that has been learned from the past in precisely the same way.

In the next two chapters, we use the benefit of experiences with these programs to suggest how these programs might be designed, implemented, and administered in the future.

A Summary of Key Provisions of the Lockheed, New York City, Chrysler, and Conrail Assistance Acts

General Categories of Provisions	Lockheed (1971)	New York City I (1975)	New York City II (1978)	Chrysler (1980)	Conrail (1974-81)
I. Type of assistance	Loan guarantees of principal & interest	Direct loans	Loan guarantees of principal & interest	Loan guarantees of principal & interest	Direct grants, loans, guarantees; USRA purchases of up to $3.6 billion in Conrail securities
II. Loan terms	$250 million maximum principal outstanding	$2.3 billion maximum principal outstanding	$1.65 billion maximum principal outstanding	$1.5 billion maximum principal outstanding	Dependent on nature of the particular act; acts approved: 1/74 (Regional Rail Reorganization Act of 1973); 2/76 (Railroad Revitalization and Regulatory Reform Act of 1976); 10/80 (Staggers Act); 8/81 (Northeast Rail Service Act of 1981)
	Payable in 5 years, 3 years renewal	Maturity at end of city's fiscal year	Maturity of less than 15 years	Payable by 12/31/90	
	Interest rate reflects interest reduction	Interest rate 1% greater than similar U.S. obligations	Reasonable interest rate	Reasonable interest rate	Reasonable interest rate
	Guarantee fee reflects administrative expense and risk		Guarantee fee of half of 1%	Guarantee fee of at least half of 1% for administrative expense required; Board authorized to charge additional fee and obtain additional compensation for risk, for example, warrants	Variable guarantee fees

	Lockheed (1971)	New York City I (1975)	New York City II (1978)	Chrysler (1980)	Conrail (1974-81)
III. Criteria for loan approval	Credit not available elsewhere	Reasonable prospect of repayment	Reasonable prospect of repayment	Credit not available elsewhere	No specific requirement except to settle claims made by trustees of bankrupt carriers and to improve facilities
	Serious impact on economy without loan		Credit not available elsewhere	Serious impact on economy without loan	
	Earning power and collateral provide reasonable assurance of repayment			Firm must remain a going concern after 1983 without further assistance, with a reasonable prospect of repayment by 1990.	
			Progress toward and eventually obtain a balanced budget	Federal assistance to be matched by concessions of about $2.0 billion from beneficiary groups	
			Continued state support		
			Independent audits		
IV. U.S. security	Full collateral raquired	Secretary of the Treasury determines security	Secretary of the Treasury determines security	Security required	Conrail is a private corporation owned by the government
	U.S. priority on collateral	Federal government may withhold other payments to city	Federal government may withhold other payments to city	In bankruptcy, debt due the U.S. paid first	

	Lockheed (1971)	New York City I (1975)	New York City II (1978)	Chrysler (1980)	Conrail (1974-81)
V. Administrator(s)	Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, and Chairman, Securities and Exchange Commission	Secretary of the Treasury and State's independent fiscal monitor[a]	Secretary of the Treasury and State's independent fiscal monitor	Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System, and Comptroller General voting members (the Secretaries of Labor and Transportation nonvoting members)	*Original act* established Chairman of USRA and 3 government board members and 7 nongovernment board members appointed by the President Northeast Rail Service Act changed board to 5 members: Secretary of Transportation, Comptroller General, Chairman of the Interstate Commerce Commission, Chairman of Board of Conrail; and one private sector person
VI. Government controls	Denial of guarantee requests	Denial of loan requests	Denial of guarantee requests	Denial of guarantee requests	Appointment of majority of Board of Directors of Conrail

[a]Although not specifically mentioned in the Act, the Secretary of the Treasury relied on the New York State Emergency Financial Control Board to oversee the City's *Financial operations*.

	Lockheed (1971)	New York City I (1975)	New York City II (1978)	Chrysler (1980)	Conrail (1974-81)
	GAO shall make detailed audits of all accounts, books, records, transactions of any borrower	GAO could audit all acounts, books, records, and transaction of the state, political subdivision, and any agency of state or political subdivision.	GAO could audit all books, accounts, transactions, and records of the city or its financing agent.	GAO could audit all accounts, books, records, memoranda, correspondence, and other documents and transaction of the corporation and any other borrower (i.e., subsidiaries)	GAO could audit Conrail's programs, activities, and financial operations, examine all books,-accounts, records, reports, files, etc. Because USRA is a government corporation GAO uses its basic authority under 31USC9103 to audit the association.
	May disapprove asset sales that may affect loan repayment			Must approve sales of over $5 million and any contract of $10 million or more	USRA--Conrail Agreement - Corporate activities must be approved by USRA board
VII. Requirements & waiver authority	Restrictions on dividends to stockholders & payments on non-guaranteed loans may be waived	Secretary may waive any terms and conditions U.S. priority rights may be waived	Secretary may waive any term and condition as well as U.S. priority rights, except guaranteed loans used to retire old debt	Restrictions on stock dividends Required amounts of concessions from some specific beneficiaries may be waived as long as total was met. U.S. priority in bankruptcy could be waived in certain circumstances	Waiver authority is held by USRA board
VIII. Federal financial bank	Did not exist; established 12/29/73	Authorized to purchase notes	Prohibited from purchasing notes	Prohibited from purchasing notes	Not mentioned

	Lockheed (1971)	New York City I (1975)	New York City II (1978)	Chrysler (1980)	Conrail (1974-81)
IX. Miscellaneous features	Board authorized to make management changes		New York City required to establish productivity council	Chrysler required to establish employee stock ownership plan and energy saving plan Department of Transportation study of auto industry and Chrysler viability required	

CHAPTER 3

GUIDELINES FOR CONSIDERING FINANCIAL ASSISTANCE FOR INDIVIDUAL FIRMS OR MUNICIPALITIES

No established mechanism exists for the federal government to evaluate and respond to an aid request from a financially distressed firm or municipality. Since such aid is an exception to the federal government's general policy of nonintervention, the Congress should consider whether the particular circumstances warrant creating a discrete aid program and, if they do, how that program should be structured.

First, there is a need to evaluate whether the problem is solely the firm's or municipality's or part of a broader industrywide or regional problem. If the problem is only the prospective borrower's, then consideration must be given to whether designing an aid program specifically for the firm or municipality will better serve the national interest than allowing market forces and established legal procedures to proceed without legislative intervention.

The latter determination should be made after carefully analyzing the probable costs, results, and consequences of offering or not offering aid. If the Congress decides that federal aid, tailored to the borrower's needs, serves the national interest, then a choice must be made among many policy options. (One option, credit assistance, in the form of direct and guaranteed loans, has been used in past programs.) Having chosen a policy, consideration should be given to structuring the program to accomplish congressional goals and objectives while protecting the government's financial interest.

Sound financial analysis is critical in addressing these questions. Firms or municipalities requesting aid from the Congress are typically larger than and tend to request more money than the normal credit recipient. Thus, the government's ability to thoroughly and fairly analyze the risks are more important than normal. Commercial lending principles and practices suggest ways for the government to evaluate a prospective borrower's financial condition, assess the risks and likely outcomes from offering or not offering aid, and structure a program that will minimize the government's risk while achieving congressional goals and objectives.

To achieve these goals and objectives, program administrators need to understand the Congress' intent. A clear and concise statement of the Congress' purpose, goals, and objectives in legislation authorizing these programs is essential. In addition, the Congress should focus all program requirements on these goals and objectives, avoid conflicting goals as much as possible, and provide guidance to program administrators on how to make the inevitable trade-offs among goals.

This chapter develops guidelines for structuring future assistance programs to deal with a specific firm's or municipality's financial problems. We provide guidance on what to think about in determining whether providing aid serves the national interest, how the government can use commercial lending principles and practices to do the financial analyses that are necessary for establishing effective programs, and how to design authorizing legislation to make the attainment of congressional goals and objectives more likely. We then show how individual financial assistance programs resemble commercial workouts of financially distressed firms in which lenders and the borrower collectively reorganize a borrower's operations and restructure its debt. Our review of workout practices and the government's experience with previous aid programs suggests several principles the government should follow in creating a financial assistance program. Specifically, the program should be structured in such a way that the government

--minimizes its financial risk,

--attains adequate compensation for the financial risks the government assumes, and

--provides effective oversight during the life of the assistance program.

DETERMINING THE NATIONAL INTEREST

When a particular firm or municipality requests assistance, the Congress should decide if the problem is specific to the requester, or is a regional or industrywide problem. Financial and economic analyses are necessary to make such a determination. In many cases, the problems facing a particular firm or municipality are not unique; its financial distress merely reflects larger economic problems facing all its competitors. In such cases, individual assistance programs may not be the best approach. Instead, the underlying structural causes of the problem may need to be addressed. The government has often developed financial assistance programs to help solve problems in specific industries or regions. The government has changed tax laws and regulations, established subsidies, and taken other steps to aid a distressed or disadvantaged economic sector or industry. Aid to an industry or region could easily prove to be cheaper and more effective than aiding each financially troubled firm or municipality.

If financial and economic analyses indicate that the problems of a firm or municipality requesting aid are primarily its own, then the Congress should compare the costs, benefits, and consequences expected to occur if assistance is offered with expectations of what would occur if market forces and established legal procedures are allowed to operate. This requires considering the effects throughout the economy, such as a possible collapse of financial institutions and markets or effects on suppliers or customers, not just the effects on the potential aid recipient.

In addition to being necessary to determine the nature of a firm's or municipality's problem, financial and economic analysis are also critical in determining whether a legislative solution serves the national interest. Financial analysis reveals the requester's true condition, tells the Congress how much aid is likely to be needed to help the requester recover, and suggests whether the consequence of not providing aid is likely to be bankruptcy. Economic analysis assesses the economic implications of both the requester's recovery and its failure.

In the past, there has been very little time to conduct the types of analysis necessary to determine the condition of the troubled firm or municipality or the consequences of providing or not providing aid. For example, when the problems of the Penn Central Railroad became fully apparent, there were only a few days to seek alternative solutions to bankruptcy. In Chrysler's case, the severity of its problems (most notably its vulnerability to an economic recession) were not fully apparent to either the Corporation or the government until after the aid legislation had been enacted. To facilitate problem analysis in the future, the government should have a way to identify and rapidly assemble a team of experts to evaluate financial emergencies that might arise. The core of this stand-by analytical capability most logically should reside in the Department of the Treasury or the Federal Reserve because the missions of those agencies require stong financial and economic analysis capability. Individuals in other federal agencies with particular industry or labor economics expertise should also be identified and made available as needed. Those federal agencies might also monitor industry conditions as part of their on-going program responsibilities to identify and monitor those firms that are experiencing operational and financial difficulties. A base of information on the evaluation of a financial problem would be useful in seeking solutions to financial emergencies and possibly could be used to alert policymakers of potential problems before a full-scale crisis develops.

Bankruptcy is one possible outcome if the government chooses not to aid a financially distressed firm or municipality. Bankruptcy is designed to determine if a firm or municipality can be reorganized and re-emerge as a self-sustaining operation. If it cannot re-emerge, then bankruptcy is designed to determine a reasonable disposition of assets and to protect the interests of the bankrupt party and its creditors.

The bankruptcy of a major producer or employer can cause a ripple effect through the economy, creating massive unemployment and endangering its suppliers, distributors, and customers. Regional and industrial dislocations may then occur, as well as decreased competition, increased public assistance, foreign penetration of domestic markets, loss of unique production capabilities, and collapse of financial institutions and markets. These secondary effects are often more critical to the economy than the initial bankruptcy.

A second possible outcome of not providing aid to a distressed firm or municipality is that creditors may decide on a plan acceptable to the firm or municipality that will avoid the need to obtain court protection. Several of the individuals we interviewed believed that in the Lockheed case, there was only a small chance that its creditors would have forced the company into bankruptcy. These individuals believed that Lockheed and its creditors would have eventually found a way for Lockheed to continue to operate without the guaranteed loans that the Congress made possible.

Accordingly, in deciding whether to provide aid, the Congress should consider both whether bankruptcy will result if no aid is provided and the implications of bankruptcy on the economy. We recognize that uncovering creditors' intentions may be difficult. We believe, however, that the Congress should use financial data to evaluate whether in the absence of federal aid the affected parties might yet agree to a plan that would avoid bankruptcy. If bankruptcy appears probable without federal intervention, then the government should evaluate whether the likely consequences can be avoided through government assistance and the costs of such assistance.

The Congress has a much better opportunity to influence a firm's or municipality's future through legislation than it would in a bankruptcy, which is a legal proceeding controlled by the judiciary. Yet, the Congress can still incorporate some positive features of a court-controlled bankruptcy in the aid package it creates. For example, Chrysler's loan guarantee program allowed the company to take the opportunity of its "new" status to renegotiate old contracts--not only labor agreements but also supply agreements (temporary price rollbacks)--and to restructure its debt agreements on more favorable terms. The Staggers Act (1980) and the Northeast Rail Service Act, (1981), allowed Conrail to increase freight rates, renegotiate labor contracts, and significantly cut back on workers and rail lines. These actions had been constrained to some extent under Section 77 of the Bankruptcy Act of 1898, as amended.[1]

Many people believe that if a municipal government declares bankruptcy and state resources are insufficient, federal aid to ensure that these services continue cannot be realistically questioned. Municipal governments provide many services that are absolutely essential to the well-being of its inhabitants and that must be maintained even in a bankruptcy but not necessarily at their previous levels. The relevant comparison for the federal government to make is between the costs of maintaining these vital services before and after a formal municipal bankruptcy.

---

[1]This Act was repealed by the Bankruptcy Act of 1978, Public Law 95-598.

Similar consideration applies when deciding whether the national interest is served by aiding companies, such as Penn Central or Conrail, that act as public utilities and provide vital services that must be maintained. If rail service in the Northeast had stopped, vital supplies and products may not have been delivered in as efficient or timely a manner. This, in turn, could have caused significant social disruption.

In the four cases we have examined, the Congress found that creating aid programs served the national interest in a variety of ways. In each case, the Congress identified some of the following national interest concerns as reasons for federal intervention:

--maintaining service or product continuity (New York City, Chrysler, and Conrail);

--maintaining employment (New York City, Chrysler, Conrail, and Lockheed);

--maintaining a defense contractor (Lockheed and Chrysler);

--maintaining a technological capability (Lockheed and Chrysler);

--preventing market penetration by foreign firms (Chrysler);

--preventing increased industry concentration (Lockheed and Chrysler);

--preserving good relations with our allies (Lockheed);

--lessening adverse effects on financial markets and institutions (Chrysler, New York City, and Conrail); and

--lessening regional, social, and economic costs (New York City, Chrysler, Conrail, and Lockheed).

A full analysis of the effect of federal intervention on the national interest requires considering possible adverse effects of providing aid that might accompany the satisfaction of some of the national interest concerns listed above. For example, by preserving one firm, the government might keep other firms in that industry from strengthening themselves by acquiring the market share that would be relinquished by the assisted firm if the government did not intervene. A domestic industry comprising a smaller number of stronger firms might be able to compete more effectively with foreign competitors. Another possibility is that providing aid might weaken market discipline if firms believe that future government aid will readily be available to

rescue them from the potentially harmful consequences of their own business decisions. This problem can be avoided, however, by ensuring that the requirements imposed in return for federal aid are so stringent that potential recipients would think of federal aid as only a last resort measure to be avoided if at all possible. Finally, one must consider that federal credit assistance, both direct loans and guarantees that reduce the interest rates that recipients pay to obtain credit, diverts economic resources away from other activities. One must balance the cost of the economic activity foregone through the nonavailability or higher price of credit against the benefits of the economic activity preserved by government intervention.

DETERMINING THE FINANCIAL CONDITION OF THE POTENTIAL RECIPIENT

Future impending bankruptcies may raise similar concerns, or, perhaps, new ones of equal importance. Evaluating a prospective recipient's past, present, and projected future financial condition will help in determining whether the government can best address these concerns by creating an assistance program to prevent bankruptcy. If an initial financial evaluation suggests that such a program is appropriate, then further analysis will help in structuring the program.

In deciding to provide aid, the government does not compare alternative investments to see if superior combinations of expected return and risk are available. Instead, the government assists a firm or municipality with full knowledge that it is unable to compete effectively for funds in commercial credit markets. Although government objectives differ from those of commercial lenders, it can frequently use principles and practices that commercial lenders follow. This section discusses some of these principles and practices and how the government can use them.

Firms and municipalities can control some risks (internal) and not others (external). These risk factors affect expectations about the value of a borrower's assets and the cash generated by its operations. Higher cash flows reduce risk and default by enabling a borrower to cover all expenses, including payments to lenders and the government. Higher asset or collateral values reduce risk because they increase the likely proceeds in the event of a liquidation.

External risk factors

External risk factors affect revenues and costs, which together help determine the financial condition of a borrower. Conditions in the Nation, region, and industry have a great influence on a borrower's financial prospects. The likelihood of a borrower's financial success is greater when the economy or its region is growing than when it is declining. When deciding whether to give financial aid to a firm, the government should evaluate both the demand for the products of that firm's industry

and the ability of that industry to meet its demand. Similarly, for aid to a municipality, the government should evaluate the factors that determine its revenues and costs.

Revenues depend on the state of the economy and other factors that determine demand for particular products or services. For example, the demand for commercial airframes is based on the demand for air travel. Thus, to evaluate a loan to be made to a commercial airframe manufacturer, the government must first evaluate the health of the airline industry to determine whether there will be a demand for planes. Lockheed experienced trouble in part because a slack national economy decreased the demand for air travel. This, in turn, decreased the airlines' immediate demand for new aircraft such as Lockheed's L-1011. This slack in the demand for aircraft, and the resulting loss of potential sales, helped make Lockheed a riskier borrower.

Similarly, the ability of a municipality to repay its loans depends in part on the local economy and the revenues the municipality can collect. A weak local or regional economy will cause local governments to lose income. At the time of New York City's fiscal crisis, its tax base had remained static or had been declining for some time. State and federal aid had not kept pace with the city's increased expenditures on municipal services.

A firm's or municipality's cost structure depends on the costs of available technologies, labor, materials, and credit. Expensive and erratic supplies, high rates of technological change, high interest rates, and high labor costs all affect a borrower's financial condition and its ability to withstand future adversities. Chrysler's financial condition was severely affected by increased oil prices; the firm sold fewer highly profitable larger cars than expected. As a result, its revenues and liquid assets were insufficient to cover its development program for the K-car.

Government tax, regulatory, and other policies are other external factors that affect a borrower's financial condition and its ability to withstand future adversities. In the 1970s, the automobile industry became increasingly regulated. All automobile manufacturers were forced to incur substantial design, engineering, and retooling costs and use more expensive, lighter materials in their cars.

In Penn Central's, and later Conrail's, case, the bankruptcy code and Interstate Commerce Commission regulations prevented significant shrinkage of unprofitable rail lines by requiring the railroads to maintain minimum levels of service despite shrinking demand for rail service in the Northeast. Thus, users of the Penn Central and Conrail rail service, such as shippers, commuters, and other passengers, did not worry about service stopping; workers were not so concerned about losing their jobs; and inefficiencies were perpetuated by government regulation and bankruptcy law.

Internal risk factors

Internal risks result from a borrower's own disadvantages or limitations. Poor management, inappropriate contracts, poor accounting and information systems, outmoded plant and equipment, and unsuccessful marketing are factors that make a company less competitive. A municipality's financial trouble spots might include deteriorating public facilities, large social or welfare costs, and inadequate accounting or financial controls.

Analyzing a borrower's internal risk depends predominantly on information made available by the borrower. However, other analysts, consultants, experts, etc. in the area in which the borrower operates should also be consulted. Their informed opinions should be considered as important as any other information in problem identification.

Sound management is critical to a borrower's ability to meet its financial obligations. The government must be convinced that management is fair, honest, and determined to repay its obligations. Management can be evaluated on the basis of previous performance, planning, financial controls, peer comments, supplier and customer relations, and personal contacts. The evaluation of management is potentially the most important and hardest task of deciding whether to provide aid. The best information for judging management's ability may be its performance in past crises.

A firm's or municipality's accounting and management information systems must be assessed. Their quality is an important factor in a manager's ability to understand how well or how poorly the organization is accomplishing its goals and why. In several programs we reviewed, a major problem was management's inability to understand the extent of the organization's difficulties because of inadequate reporting systems.

Another internal factor to examine is a firm's ability to be competitive in the markets in which it operates. When a firm's competitive position has been suffering, temporary government aid may allow it to introduce new products or improve its service to reverse its competitive decline. One reason Chrysler was aided was so that it could introduce its innovative K-car, an intermediate-sized passenger car with a small, four-cylinder, fuel-efficient engine that many believed would contribute to the Nation's energy conservation efforts and reduce market penetration by foreign firms. With respect to the Northeast railroads, many people believed that an infusion of funds through Conrail would drastically improve the competitiveness of rail service by improving equipment and maintenance and, as a result, the quality of service.

Operating and financing plans, which integrate internal and external risk factors, should be assembled and examined. Since it is not necessarily standard practice to prepare such plans, recipients should be required to do so as a condition of any assistance program. Creating such plans covering at least 5

operating years is a good exercise because they help focus everyone's attention on vital issues and direct attention to remedies that will be oriented toward the future.

Measuring risks

To evaluate the cumulative effects of external and internal risk factors, analysts usually create summary measures of the current and expected future financial condition of a borrower. Traditionally, these measures have been earnings protection (coverage), financial leverage, and liquidity. These measures are also useful for evaluating the risk in aiding a distressed firm or municipality.

Earnings protection or coverage

Earnings protection or coverage refers to a borrower's ability to generate sufficient cash flow to pay all expenses, including loan payments. Most people we interviewed said that cash flow is the most important factor in a company's survival. Available tax revenues and municipal costs will determine a municipality's coverage. Coverage for a private company is based on profitability, return on investment, pre-tax profits, the ratio of cash flow to debt service, earnings growth, financial solvency, and other factors that determine whether a company can cover its obligations regardless of future adverse circumstances.

In practice, actions that appear to decrease risk by increasing cash flow may actually increase risk because of the resulting effect on asset values. For example, a loan may increase cash flow by financing the acquisition of new and unique machine tools designed to increase a borrower's productivity. But this unique equipment may be of significant value only in current operations of the company and of little value to any other manufacturer if it had to be sold. Furthermore, sale of valuable equipment to increase cash flow can impair viability.

Financial leverage

Financial leverage measures the extent to which a borrower's investments depend on loans rather than the borrower's own resources. A highly leveraged firm tends to have a high ratio of debt to equity. Since debt service costs are fixed, a downturn in the economy that decreases revenues also decreases the margin between cash flow and debt service payments. This leaves less cash to meet other expenses. In the extreme a borrower could be forced to liquidate or enter bankruptcy. Because net worth is small in a highly leveraged firm, the sale of a firm's assets in a liquidation may not produce enough money to repay outstanding debt, causing some lenders to incur a capital loss. Thus, other things being equal, lenders prefer less leveraged firms.

Liquidity

Liquidity is a measure of a borrower's ability to meet current obligations from liquid (readily available) assets. For

example, cash balances are totally liquid, government securities are fairly liquid, while manufacturing plants and unique equipment cannot be quickly converted into cash. Liquidity represents the ability of the borrower to repay a short-term loan in the extreme case when it is no longer generating any cash revenues.

For example, New York City regularly covered its operating deficits by floating bonds. This meant its liquidity depended on loans. While the city's ability to pay its non-debt related expenses was decreasing, it was increasing its leverage. Ultimately, lenders recognized that this dependence on loans to cover current expenses was financially unreasonable and credit was no longer available.

Penn Central and Lockheed faced similar problems. During its last year, Penn Central's current revenues did not cover current expenses, and it paid bills with liquid assets. When it tried to enter the credit market to replenish its liquid assets, its inability to cover current expenses from current revenues became apparent. Using loans to pay current costs was not wise in the long run because Penn Central could not obtain further credit. As indicated previously, Lockheed's costs of developing a new product and bringing it to market exceeded its expectations. As cash was drained to cover bills, lenders decided that the prospects for the new products were too risky to continue to support the firm.

Evaluating risk

Many techniques are available to the government to forecast a borrower's financial condition and evaluate the risk levels. Financial analysis is commonly performed by government agencies responsible for programs in which loans or guarantees are offered. A strong knowledge and understanding of the industry of the potential credit receiver is required if a thorough and fair analysis is to be performed.

Ratio analyses compare various figures in financial statements to determine the risks implied by different levels of leverage, liquidity, and coverage. These ratios are compared to industry averages to determine if a borrower is more or less risky than others in the industry. Also, the ratios are compared over time to determine whether a borrower is becoming more or less risky.

Using pro forma statements--projected financial statements of a borrower during the time that a loan is outstanding--is a common technique. Figures in these statements are generated by expert judgments, formal forecasts, and/or econometric models and are based on expected external and internal conditions. These figures are used to evaluate risks as reflected in measures of a borrower's leverage, liquidity, and coverage. They can also be used to determine the extent to which the operation of the borrower has satisfied other congressional goals.

Analysts often subject these figures to sensitivity, break-even, or ratio analyses. Sensitivity or break-even analyses vary the assumptions about future external and internal conditions to determine the range of error possible in the projected cash flow and asset values without creating too much risk or substantially reducing the likelihood of obtaining congressional goals. The more sensitive these measures are to varying assumptions, the more risky the loan.

ASSESSING FINANCIAL CONDITION SHOULD GUIDE PROGRAM STRUCTURE

The assessment of a firm's or municipality's financial condition should be used in designing an effective aid package. Some key elements that might vary, depending on the aid recipient and the magnitude and source of its financial problems, include

--the amount of federal aid needed to return the recipient to viability,

--changes that must be made in existing contracts that would otherwise prevent a return to viability, and

--the amount of time before the recipient should be required to begin repaying the government.

Through pro forma analysis, estimates can be made of a firm's or municipality's future financial condition both if no aid is provided and under different assumptions about the federal aid package offered. This analysis will show by how much revenues are expected to fall short of costs during specified intervals if no aid is provided. From this, one can estimate the amount by which these figures must change for the firm or municipality to survive and create an aid package that will accomplish that result.

The aid package created need not rely exclusively on government sources. If the Congress determines that the amount needed exceeds the amount consistent with the risk level it is willing to accept, then it should include other revenue-raising or cost-cutting features in the program. Particular attention should be paid to examining existing contractual agreements to identify contracts that, if left unchanged, are likely to prevent the firm or municipality from returning to viability. These contracts might be agreements with workers, creditors, suppliers, dealers, customers, state and local governments, or others with whom the recipient interacts.

Although contract changes that increase cash flow by a given amount are equally useful regardless of the source, a review of the recipient's contracts might suggest ones that seem particularly troublesome, or for which the other party is likely to be willing to accept a change to ensure that the firm or municipality receives federal aid. Contracts that impose costs far greater than those experienced by competitors and contracts with

parties extremely dependent on the borrower's survival for their own well-being are likely to fall into that category. (See concessions p. 40.)

In determining the length of the program, the government must balance the aim of keeping the program as brief as possible against the need to allow the recipient enough time to revive before requiring it to begin repaying the aid. A definite date by which all loans must be repaid is necessary to assure that any program is temporary. And the sooner repayment is required, the more incentive the recipient's managers will have to take the actions necessary to improve their organization's financial status. But on the other hand, requiring repayment too early might remove funds that the recipient needs for investment to ensure its long-term viability. Analysis of pro forma financial statements may suggest when the recipient will be able to begin repayment without jeopardizing its future.

Choosing a policy

If, after reviewing the financial analysis and potential effects of providing or not providing aid, the Congress decides that a legislated aid program best serves the national interest, then it must choose the form of assistance to be provided. Among the options available are government equity participation (or even nationalization), a creditor relationship, tax relief, regulatory relief, and various subsidies. Tax and regulatory relief are not easily targeted to a single recipient, and the relief they might provide may not be available (if, for example, a firm pays no taxes) or may take too much time to improve cash flow. The direct and guaranteed loans the government has provided in past programs reduced the cost of acquiring funds and allowed the assisted parties to quickly get a large infusion of capital that otherwise would not have been obtainable. These loans are easily targeted to a specific borrower and impose the market discipline of a creditor relationship between the borrower and the government.

The government can establish a creditor relationship with a failing firm or municipality through two principal methods. The government can directly loan funds or guarantee repayment of all or part of the principal and interest on loans made by private sources. The government may appear to be less at risk by guaranteeing a loan because no government funds need to be spent until and unless the borrower defaults on its obligations. In fact, however, there is no significant difference in risk exposure between direct and guaranteed loans. If a borrower defaults on a direct loan, the government will suffer a loss equal to the loan principal plus any interest due the government that was not paid before the default, less the value of the collateral the government obtains in a liquidation. The unpaid interest must be considered a cost even though it is not a direct outflow of cash from the Treasury because it is income the government might have received by lending to someone else. For a default on a guaranteed loan, the government again loses the loan principal plus any

unpaid interest due the lenders, less the collateral value of the assets pledged to the government. Any small difference in risk exposure that might exist would be due to a difference between the interest rate charged by private lenders on guaranteed loans and the interest rate the government would charge on direct loans. The experience of past programs suggests that lenders are willing to make guaranteed loans at interest rates slightly higher than the rates at which they will lend to the government.[2] Therefore, if the government charged borrowers a rate equal to its own borrowing cost, then the cost to the government, in the event of default, and, therefore, its risk exposure, would be slightly less with a direct loan.

Direct and guaranteed loans can differ substantially in the degree to which they are subject to oversight and the way they are treated in the budget and appropriations process. Traditionally, guaranteed loans have not been included in budget totals because no initial outlay is made. As a result, they often have received less attention and oversight than other programs. The Lockheed, New York City, and Chrysler loan guarantee programs have been exceptions to this generality. Their size and controversy caused these loan guarantees to receive considerable attention from the public and the Congress. In addition, for the Chrysler aid, an explicit appropriation was made. Accordingly, although direct loans generally provide greater assurance of accountability and oversight, experience with these programs suggests that little, if any, oversight is lost if loan guarantees are authorized.

Besides their substantive differences, direct and guaranteed loans may differ in appearance in ways that are important to the success of the program. Because a loan guarantee requires no immediate expenditure of federal money, it may be easier to obtain the political consensus needed to establish a guarantee program. Accordingly, the government might be able to respond more quickly with a guarantee than with a direct loan. In addition, in comparison with a direct government loan, a program in which banks and other lenders actually provide the loan--with the government

---

[2]Part of the premium lenders would require on a government-guaranteed loan might be a "liquidity premium." Because far fewer guaranteed securities exist than Treasury securities, the resale market is less active and holders of those securities might not be able to convert them to cash as readily. Another possibility is that lenders are concerned that if the borrower defaults, there might be some delay before they receive their money from the government. A third possibility is that the administrative costs of raising funds privately might exceed the Treasury's fund-raising costs; these additional costs would need to be covered in the interest received by lenders. Yet a fourth possibility is that the premium is partly due to the "call" feature of the guaranteed loans; lenders typically charge premiums when borrowers can repay the loans, i.e., "call" them, before maturity.

as guarantor--may enhance the probability of financial recovery by the borrower. Some of those we interviewed said that people might interpret the willingness of these lenders to be part of the program as an indication that the borrower's prospects for recovery are good. Anything that increases public expectations that the recipient will recover may actually increase the likelihood of recovery, particularly if the recipient sells its product to the public.

PROGRAM REQUIREMENTS SHOULD BE DIRECTED AT CONGRESSIONAL GOALS AND OBJECTIVES

The reasons for establishing these programs and the results they are supposed to produce can vary. A thorough understanding of congressional intent is important if administrators are to run each program effectively. Therefore, the Congress should include a clear and concise statement of its purpose, goals, and objectives in the authorizing legislation. In addition, the Congress should ensure that legislated and administratively determined requirements further the attainment of those goals and objectives.

An effective assistance program cannot be established unless the Congress decides exactly what purpose the program will serve. Knowledge of a program's purpose will influence the way people think about what they are trying to accomplish in the program and provide a criterion on which to base all program decisions and a basis for monitoring progress.

Sometimes in past programs the legislation has not made the Congress' intent clear. For example, was the major intent of the Conrail program to save jobs, or to assure rail service? Several people we interviewed stated that for several years this question was unresolved because the 1973 Regional Rail Reorganization Act required the creation of a profitable rail service system without adversely affecting employment. Maintaining employment at pre-aid levels is problematical because pursuing such a goal will often conflict with cost-cutting actions necessary to return a firm or municipality to long-term self-sufficiency. Without knowing what to use as the primary goal, one will have difficulty deciding what steps are appropriate to each program goal, and it will also be difficult to judge whether a program has succeeded.

A clear statement of congressional goals and objectives and standards by which success in meeting those goals and objectives can be measured are needed in the authorizing legislation. Statements of goals and objectives should

--identify intended benefits, including expected levels of attainment;

--identify unavoidable adverse consequences, such as harming Ford Motor Company and General Motors by aiding Chrysler or unintended benefits, such as improving the financial position of Chrysler's public bond holders by not requiring their participation in concessions;

--include to the extent possible measures of desired degree of attainment; and

--provide guidance to administrators on how to make trade-offs among conflicting aims.

Simple statements of goals that reflect the national interest, such as preserving employment in the auto industry or assuring public safety, are too broad to meet this criteria. Without measureable standards, goals are difficult to address when administering an aid program. For example, if a goal is to maintain employment, at what level should employment be maintained for a program to be judged a success? Program structure hinges importantly on this consideration. Chrysler now employs approximately half the number of workers it did before the loan guarantee program went into effect. Can it be said that the goal of "maintaining employment" has been met?

If one views objectives as the accomplishments that the Congress is seeking from the assistance programs to attain its goals, measurable objectives can be written. For example, an objective might be the reemergence of Lockheed or Chrysler as a self-sustaining corporation with access to private capital markets without additional federal aid. The success or lack of it in attaining this objective can be easily determined.

Conflicting goals and objectives should be avoided as much as possible. When conflicts occur, the fulfillment of requirements that further the attainment of one goal or objective might reduce the likelihood of attaining another. As a result, the costs of an aid program rise, and the probability of success and the likelihood that accomplishments will meet expectations fall.

In particular, requirements that direct the recipient's management and the program administrator to pursue certain goals, such as maintaining the firm's or municipality's employment level, may prevent cost-cutting actions necessary to return to self-sufficiency. Alternatively, they may lead to larger than desirable cuts elsewhere, such as in research and development, marketing, maintenance or, for a municipality, public facilities improvements, that also hurt the recipient's long-run financial condition.

Some conflict among goals and objectives is probably unavoidable. Therefore, in establishing requirements that must be met in return for federal aid, the Congress should evaluate the effects of such requirements on the likelihood of obtaining each goal and objective. The Congress should also direct the program administrator to perform a similar evaluation of requirements it imposes and provide guidance on the relative priorities of congressional goals to assist administrators in making trade-offs.

It is not possible to provide a simple operational rule on how to make these trade-offs. In general, they should be based on

--the relative importance of attaining each goal and protecting the government's financial interests, and

--the effects of a particular requirement on attaining each goal and protecting the government's financial interests.

When the Congress believes that a particular goal or objective should be attained, then it should write the legislation to address that goal or objective as directly as possible. For example, during the congressional debate on Chrysler, its new K-car was discussed as being important to the Nation in meeting its self-sufficiency energy plan and preventing foreign manufacturers from further penetrating the U.S. auto market. But nothing in the legislation assured that Chrysler would continue to produce such vehicles by providing, for example, for a minimum level of research and development expenditures or minimum employment levels of engineers and scientists to continue to develop these autos.

The Congress should avoid imposing requirements that are extraneous to the central purpose of the program. Fulfilling these requirements diverts the time and effort of both recipient and government officials from the most important issues. Such requirements have sometimes been included in previous programs. For example, requiring Chrysler to develop an energy-saving plan, employee stock ownership plan, and a productivity improvement plan were legislative requirements that most people with whom we discussed this question believed were unnecessary to the overall goals of the program. Many believed that the productivity council in the New York City program was also unnecessary.

FEDERAL CREDIT ASSISTANCE PROGRAMS RESEMBLE COMMERCIAL WORKOUTS

Commercial workouts of distressed firms occur when all parties agree that their financial interests are best served by restructuring the borrower's debt and reorganizing its operations. In a workout, lenders will often agree to adjust loan terms in the belief that aiding the borrower to avoid a bankruptcy or liquidation is in their own self interest. Lenders may prefer workouts, especially when the value of any collateral is insufficient to cover debts. Also, bankruptcy courts are concerned with rehabilitating the debtor as well as with the potential losses of the creditors. As a result, in a reorganization under the bankruptcy code, courts often limit claims of lenders against a borrower to give the borrower a second chance.

The management of a distressed firm may also believe it is in the interest of its owners and bondholders to continue to operate rather than go through bankruptcy or liquidation, which would deplete the firm's assets and force the bondholders and stockholders to experience additional losses. Therefore, management may offer the lenders concessions, such as warrants or equity in the restructured firm, to provide incentives for continuing

credit. The management may also be willing to accept stronger oversight by lenders to ensure that it will restructure the debt and make new loans.

Commercial workout specialists we talked with told us that to preside over a successful workout they must understand the actual and potential financial condition of a distressed firm and determine the ability of concerned parties to negotiate a package that is beneficial and feasible for everyone. They told us that workouts are unstructured, complex, and burdensome because the parties have disparate and conflicting financial interests that must be addressed. But the parties often agree to an organizational and a debt restructuring when those steps will make everyone better off compared to the alternative of bankruptcy.

A Federal credit assistance program is more complicated than a commercial workout because it also includes the government as the new lender or loan guarantor and other interested parties, such as labor; suppliers; customers; dealers; and local, state, and foreign governments. As a result, the number of parties with varying financial interests increases as does the complexity of the negotiations. But the basis of the final deal remains the same. The parties will cooperate with a federal credit assistance program only if the program offers a better alternative than bankruptcy or liquidation. The government should always keep this point in mind in attaching conditions to its assistance programs.

CONCESSIONS REDUCE RISK

After determining the total financial needs of the distressed borrower, the government can reduce the need for federal assistance, and therefore its risk exposure, by requiring that the beneficiaries of such aid also contribute to the borrower's recovery. These concessions can be in the form of either an immediate cash infusion or renegotiated contracts that reduce future operating costs or increase future revenues. Such concessions give the beneficiaries of the assistance package a stake in the financial success of the borrower provided that, in general, only its full recovery, termination of its obligation to the government, and re-emergence as a credit-worthy borrower enable the beneficiaries to renegotiate their contracts and withdraw the concessions.[3] Furthermore, while concessions should clearly be a key component of initial program structure, the possibility should not be ruled out that over the life of the program

---

[3]Sometimes concessions need not be in place for the duration of the program. In some cases they may only be required during a particularly difficult period for the firm or municipality. For example, the wage concessions granted by Chrysler's workers in 1981 were renegotiated at the termination of existing union contracts, and, because of the improved financial condition of the company, some of the concessions were eliminated.

additional concessions might be required. If, for example, the financial condition of the borrower becomes even worse than originally anticipated, further concessions may be required of the affected beneficiaries. Concessions also help the program appear fair because everyone who stands to benefit from it contributes financially.

The extent of the concessions obtained from each beneficiary depends on (1) the costs to the government of obtaining the concessions, (2) the value of the concessions to the assistance program, (3) the costs of the concessions to the beneficiaries, and (4) the value of the assistance program to the beneficiaries. Due to these differences in costs and benefits, the relative sacrifices of the beneficiaries may vary.

Many different classes of beneficiaries provided concessions in previous programs. We will discuss each group in turn.

Creditors

Because creditors (particularly unsecured ones) tend to lose a lot in a bankruptcy or liquidation, they should be considered prime candidates for concessions. Creditors are important to the revival of the distressed firm or municipality because changes in the structure of the debt can ease cash flow burdens. Lenders can make three types of concessions to increase the borrower's cash flow: (1) they can adjust the terms of loans to reduce the size of the periodic payment, (2) they can trade debt for various forms of equity, and (3) they can offer new loans.

All these concessions were common in previous federal assistance programs. In the Lockheed program, the banks made both guaranteed and unguaranteed loans. In the Chrysler program, the banks first extended maturities and forgave interest and, later, received preferred stock and traded debt for warrants--the right to acquire stock in the future at a set price. The warrants acted as a risk premium for the lenders.

Lenders typically have given up their priority claims on assets, subordinating them to the claims of the federal government and permitting the government-guaranteed loans to be repaid first. The lenders did this because the possible gains from the new federal credit assistance programs exceeded their expected gains from a bankruptcy or liquidation.

Stockholders

The owners of a private company hold the final rights to all the profits. In the event of a bankruptcy or liquidation, they can only get what remains after all other claims have been satisfied. Therefore, they have a strong incentive to cooperate. Usually, they forgo dividends and accept a dilution of their interests, as equity or warrants are offered to other participants

in exchange for fixed payment obligations.[4] However, when the government purchases a corporation's assets and operations, as it did in the Penn Central case, stockholders do not make this type of concession. The Constitution requires the government to provide just compensation when taking private property. In the Penn Central case, this compensation, in conjunction with the loss of the unprofitable rail operations, left the corporation and its stockholders in a favorable financial condition.

Bondholders

The number of holders of a corporation's or municipality's outstanding publicly traded debt and the difficulty of identifying them make it hard to obtain concessions from bondholders. Furthermore, the financial value of their concessions and the costs of organizing a program to obtain them often are not worthwhile because concessions from other parties are either easier to obtain or offer more cash. When concessions have been obtained from this group, it generally has been through the offering of one form of debt for another that results in extended maturities. Concessions were not always obtained in the previous four programs, and the holders of publicly traded debt obtained considerable gains relative to what they may have received in a bankruptcy without making any concessions.

Management

Management can make financial concessions, such as salary cuts or lost perquisites, such as use of corporate-owned aircraft. These concessions are made more for appearance's sake and have little effect on the viability of the distressed borrower. But the loss of one type of perquisite, stock options, does offer strong financial incentives for management. Because option rights can be very lucrative for managers, they have a strong incentive to ensure that the company re-enters credit markets without further assistance. This can be an especially strong incentive when the exercise of options is conditioned on a return of the firm to self-sufficiency.

Management's main concession is losing its operating autonomy. This could be as drastic as losing its control of the organization if the federal government believed that the current management were incapable of ensuring that the organization would re-emerge self-sustaining, which happened in the case of the bankrupt railroads that formed Conrail. This did not occur in the other programs. Instead, the federal government retained the right to review and approve financial and operating plans and contracts. The government did this to ensure that the recipient's operations did not endanger congressional goals or impose financial risks.

---

[4]Offering equity or warrants to other participants is an incentive because the reemergence of the distressed firm as a viable company will increase the value of either warrants or stock.

Losing autonomy is particularly chafing to high-level managers. The implications of this loss of autonomy due to review and approvals of plans, operations, and contracts is more fully discussed in subsequent sections of this chapter.

Labor

Labor should be seriously considered when concessions are sought because wages and benefits often represent the bulk of a distressed firm's or municipality's costs. Bankruptcy or liquidation can lead to loss of jobs or significant salary cuts. To the extent that similar jobs are not readily available at similar pay or workers have difficulty in relocating to obtain similar jobs, labor is especially dependent on a firm's continuation. Labor concessions can take many forms, such as immediate wage or benefit cuts, reduction or elimination of scheduled future increases, altered work rules, and modified cost of living adjustments.

The extent of labor concessions in previous programs has varied for several reasons. In one program, Lockheed, the level and nature of risk were such that significant concessions were not considered. In another program, Conrail, many interviewees suggested initial labor concessions were insignificant compared to the type of cost cutting needed to provide financial relief. They suggested this was due to the political strength of the rail unions and an underestimation by the United States Railway Association of the real extent of Conrail's problems. As indicated previously, when subsequent analyses revealed that Conrail would remain unprofitable, the Congress enacted the Northeast Rail Services Act in 1981 to decrease labor protection and require needed labor concessions. In the New York City and Chrysler situations, the level of risk and congressional concerns ensured that significant labor concessions were obtained.

Suppliers

Suppliers whose main or only customer is the distressed firm or municipality should make financial concessions. They can supply more goods or easy credit or lower prices to ensure the survival of an important customer. Such concessions were present in the Chrysler program. Suppliers who do not depend on the recipient have little incentive to make concessions, and concessions should not be sought from them, unless the potential benefits outweigh the costs.

Customers and dealers

These beneficiaries will make concessions whenever they have significant deposits at risk or their business success depends on the recipient's survival. Lockheed's customers increased their prepayments to ensure the ultimate delivery of the L-1011s because they were depending on the plane to provide service in the coming decade. Similarly, Chrysler dealerships offered concessions because their livelihoods depended on the continued

operation of Chrysler. If Chrysler failed they would probably have found it difficult to profitably dispose of their inventory. Chrysler's automobile customers did not make deposits to ensure that Chrysler products would continue to be available; numerous other automobile suppliers existed. Furthermore, unlike Lockheed's customers, Chrysler's customers would not have been easily identified. In the New York City situation, the taxpayers (customers) made concessions by paying higher prices (taxes) and receiving fewer services.

State and local governments

State and local governments can be induced to make concessions to ensure future tax collections and employment for their residents. They can lower taxes, offer loans and industrial revenue bonds, decrease regulatory burdens, or offer other advantages that increase the recipient's cash flow and improve its prospects. For example, in the Chrysler program, state governments offered secured loans. In the Conrail program, local and state governments helped pay for unprofitable commuter and freight rail services on local rail lines. In New York City's case, state involvement was crucial to the success of the program.

Foreign beneficiaries

These beneficiaries are a combination of all the types of beneficiaries discussed and as such should make similar concessions. Of course, the extent of concessions made by foreign beneficiaries depends on the added constraints imposed by our foreign policy needs. But in both the Chrysler and Lockheed programs some concessions were obtained. For example, foreign banks agreed to renegotiate the terms of their loans to Chrysler.

The Congress should require specific concessions

Concession negotiations are complex and require that all participants understand the financial implications of any deal or concession offered during the process. Without such knowledge, negotiators are incapable of protecting their own financial interests. Such detailed knowledge and the time needed to develop an appropriate set of concessions are often not readily available to the Congress, making it hard to participate effectively in such discussions or make evaluations of the financial reasonableness of any concessions or deal. Further, such complex negotiations and the need to resolve varying beneficiaries' interests are not easily handled in public forums, such as congressional hearings. Observers generally believe that concessions should be legislated despite the complexity they add to the program and the potential burden they impose on program administrators in working out a deal that abides by the legislated terms. A broad outline of the concessions or deal needed for a credit assistance package should be negotiated, if possible, before the problem reaches the Congress.

Since concessions may not always be agreed on before the Congress is approached for assistance, some concessions will need to be induced by the Congress. In some cases, concessions will only be made when the Congress makes it clear that it require the beneficiaries to contribute as a condition for aid. Many observers feel that this problem is best represented by the need to get union membership to approve contracts with give-backs or other concessions. The limited concessions initially offered by Conrail employees is usually cited as a classic example of this situation. Therefore, the Congress should legislate specific concessions when beneficiary offerings are either not forthcoming or insufficient. However, the legislative language should allow the agent overseeing the programs some discretion in the negotiating process (see p. 52).

FINANCIAL AND OPERATING PLAN AND CONTRACT APPROVALS REDUCE RISK

A second way that the Congress can reduce the government's risk exposure is to require that the assisted firm or municipality receive government approval of its financial and operating plans and new major contracts. The commitments the recipient makes through these plans and contracts will determine the scope and direction of its future operations. Therefore, the government should review these plans and contracts to determine their implications for the recipient's anticipated costs and revenues. The government should approve them only when it judges that the level of risk they impose on the government is acceptable and consistent with congressional goals.

Governmental review and approval does not mean that the program administrator should manage the recipient's operations and draw up its plans. Everyone with whom we discussed this issue agreed that day-to-day decisions and even long-run planning are best left to the recipient's management because it is likely to have more expertise in these areas than federal officials. Most believed that the government had not tried to manage the recipients directly or interfere with management except in Conrail's case.

When the government rejects a proposed plan or contract because it is too risky, it should not attempt to amend the proposal to reduce the risk. If the government were to make such amendments, then it would be responsible for the results of these decisions, a role best left to the recipient's management. Instead, the government should advise management that it judges the proposal to be too risky. This outcome may occur when projected profitability or cash flow are too low or because the assumptions behind profit and cash flow projections are unrealistic. Management would then be obligated to make necessary changes and resubmit the plan or contract for approval. But the approval or rejection rights ensure that the management's overall direction remains consistent with the congressional goals and the need to reduce risk. We believe that annual review of operating and financial plans is appropriate, but review could be more frequent

when new plans must be drafted because the recipient's program radically departs from that planned.

The Congress should establish criteria for determining which contracts and plans should be reviewed to ensure that the administrator does not try to deal with the recipient's day-to-day operations. These criteria should be based on a financial evaluation of the recipient. For example, the Congress should specify a minimum value below which government approval of contracts is not required. This has been done in the past, but the value set might not have been appropriate. Chrysler officials and others told us that the $10 million figure used in that program to determine which contracts to review was far too small for a company the size of Chrysler that regularly signed much larger routine contracts with its suppliers. Although we did not try to determine if, in fact, this limitation significantly affected Chrysler's profitability, we do believe that setting a low figure can cause unnecessary government paperwork and inefficient operations.

To a great extent, the review process serves as an aid to management. Because the plans and contracts have to be approved by government officials with less expertise than the management, especially clear and exact plans that reveal the reasoning and assumptions that underlie them are required. When management develops such plans, it may get a clearer understanding of its assumptions and also obtain criticisms from an intelligent and concerned outsider. This, in turn, may improve the plans.

We recognize that the federal government's ability to review and control the operations, plans, and contracts of a municipality receiving federal assistance is limited. Municipalities are legal creations of the states, and the Constitution requires the federal government to permit the states to monitor them. Thus, when a municipality receives credit assistance, the Congress should require the state government to be the primary reviewer and controller of the municipality's operations and contracts. In the New York City assistance program, New York State used the Financial Control Board to fulfill this role. However, the Secretary of the Treasury was required to ensure that the Financial Control Board was limiting the risks associated with the program. In these circumstances, however, we believe the state should be required to share substantially in the risks associated with the assistance program, as happened in the New York case through the involvement of the Municipal Assistance Corporation.

ADEQUATE COLLATERAL SHOULD BE REQUIRED TO REDUCE RISK

A third way that the Congress can reduce the government's risk exposure is to require that (1) the assisted firm or municipality maintain collateral whose value exceeds the amount of direct or guaranteed loans outstanding and (2) all other lenders subordinate to the government their claims to the collateral. While concessions and plan or contract approval reduce risk by

limiting the government's exposure and making it less likely that the recipient will be unable to repay its obligations, collateral requirements reduce risk by ensuring that the government will not come away empty-handed in the event of a bankruptcy or liquidation.

Ensuring the presence of adequate collateral requires three actions. First, the government must review actual and pro forma balance sheets to identify potential collateral, such as marketable equipment, buildings, and land. Second, the government must ensure that the collateral actually exists or will exist and will be available if bankruptcy or liquidation occurs. This implies that liquid assets, such as financial paper or cash, may not be good collateral unless the government controls their disbursement. Such control is possible if the government requires that the recipient maintain separate accounts in commercial banks that hold liquid collateral. In such a situation, it would take federal permission to sell or use such assets. Thus, the recipient would not be able to use or disburse the liquid collateral before a bankruptcy or liquidation.

Last, the government must determine the liquidation value of the collateral, since its value to the borrower may be much more than its value to others. The best assets for use as collateral are widely used items that have value to others. For example, the market value of a typewriter is probably well known, but the value of specialized inventory, such as auto parts or unique manufacturing equipment, may be very little if the firm ceases operations. Furthermore, a quick sale will reduce the proceeds from unique assets if there is not much of a market for them. As a result, the collateral may have to be held by the lender after obtaining title to prevent the sale of the assets from depressing the market price. Thus, the lender may have to wait to recover the funds lost in a bankruptcy or liquidation. In view of this, the federal government should ideally require collateral in excess of the outstanding loans by an amount sufficient to compensate it for the time and expense of holding the assets and the uncertainty associated with their resale value.

In establishing collateral requirements, the Congress should recognize the trade-offs these requirements impose. Ensuring the availability of sufficient collateral may protect the government against losses, but it also decreases the flexibility of the recipient as it deals with changing circumstances. Some assets become obsolete or no longer necessary to the operations of the firm and should be sold. If this is prevented or impeded, it may affect the efficiency of a firm's operations and, in turn, decrease the likelihood that the firm can generate sufficient cash flow to recover. In other words, increasing protection in the event of default may increase the likelihood of default. This trade-off should be considered in setting collateral requirements, but reasonable collateral requirements should still be included in the package.

When aid is provided to a municipality, collateral is probably unobtainable. Even if a municipality enters bankruptcy, its physical plant and equipment cannot be used to satisfy federal claims because services must be maintained. Furthermore, many municipal assets, such as bridges and city streets, cannot be readily sold or used by others. It might be possible for the federal government to require the state to assign certain revenue sources to the payment of loans created by the assistance program as New York State did to cover the Municipal Assistance Corporation debt. This is analogous to revenue-based municipal bonds that might be paid by a city's water or bridge revenues. But the extent of any federal claim would be significantly restricted by the need to ensure that local residents could still afford to purchase or use local services, such as water and sanitation facilities.

THE GOVERNMENT SHOULD RECEIVE ADEQUATE RISK COMPENSATION

The government is not solely motivated by financial considerations when it offers credit assistance to a firm or municipality that is too risky for a private financial workout. Although the government obviously would prefer not losing money in these programs, the reason for creating them is not to make money. Nonetheless, the government is entitled to some compensation in return for obligating federal funds, particularly if the program succeeds in restoring the recipient's financial health. Therefore, the Congress should require such compensation in all future programs.

There are two basic forms of risk compensation that the government might use:

--increased periodic payments in the form of higher interest rates or guarantee fees, and

--equity participation in the form of issued shares or warrants.

Commercial lenders typically adjust the interest rate in accordance with the perceived risk level. As risk increases, so will interest rates. In a government loan guarantee program, lenders, not the government, receive the interest payments, and the very existence of the guarantee reduces risk borne by lenders and lowers the interest rate they charge. In fact, the decreased interest rate is a major program advantage because it reduces the borrower's cash flow drain.[5]

---

[5]Although the guarantee does significantly lower risks, commercial lenders still require a small premium on guaranteed loans compared to Treasury securities. Reasons for this are provided in footnote 2, page 36.

Accordingly, the government must rely on other methods of receiving risk compensation, such as loan guarantee fees charged to the borrower or equity participation through warrants or other means of sharing in the potential recovery of the borrower. The Congress has used loan guarantee fees of different amounts in past loan guarantee programs. In the Chrysler legislation, the Congress also authorized the board it established to administer the program to obtain additional compensation by, for example, obtaining Chrysler's agreement to issue it warrants to purchase Chrysler stock.

Requirements to compensate the government for risk create desirable incentives for both those receiving assistance and others that might consider applying for assistance in the future. For example, loan guarantee fees based on the value of guaranteed loans outstanding provide an incentive for a borrower to repay guaranteed loans as quickly as possible and/or not use all of the guarantees available. In addition, if potential aid applicants know that the government will demand risk compensation, they will be less likely to seek aid.

Many people also believe that risk compensation requirements add to the appearance of fairness by reducing the competitive advantage the government assistance confers on an assisted firm. On the other hand, a few of the people with whom we discussed this issue believe that the government should not seek monetary risk compensation because attaining the social goals of the program would be sufficient compensation. If risk compensation were not required for this reason, how the desirable incentive effects could be built into the program would be unclear.

If the recipient found it advantageous to compensate the government in accordance with the actual risk level, then a private workout probably should have occurred. Therefore, in establishing risk compensation requirements, the Congress should recognize that it might be impossible to design a program that will fully compensate the government yet still induce the recipient to reject bankruptcy.

Recognizing that risk compensation requirements can delay the recipient's return to viability and unassisted entry to commercial or municipal credit markets is important. Any form of risk compensation imposes a current or future cost on the recipient. High loan guarantee fees, in particular, may weaken a borrower's ability to repay its loans because of the drain on the borrower's cash flow. A loan guarantee fee designed to give the government full risk compensation would probably need to be so high--much higher than in past programs--as to significantly affect the borrower's cash flow. As a result, many people believe that obtaining full compensation through guarantee fees is not possible and that the government should use equity participation as its chief compensation mechanism. We believe that although equity participation is often appropriate and should always be considered when aiding a firm, the decision to include it as a program feature, as well as its extent and form, should be made on a case-by-case basis.

Equity participation does not impede the recipient's cash flow. Indeed, in the case of warrants, they have real value only if the firm begins to recover and its stock price rises above the level at which the warrants can be sold or exercised. Nonetheless, the existence of warrants, like loan guarantee fees, may affect the borrower's access to capital markets. The possibility of a large increase in the number of outstanding shares due to the government's exercising or selling its warrants will dilute the value of any new stock the firm might issue to acquire capital. This dilution occurs because exercising the warrants spreads the firm's profits among more owners. Therefore, in deciding how much risk compensation to obtain, the government must balance the need to create appropriate incentives and maintain an appearance of equity against the potential delay of the firm's re-entry into capital markets.

Although the Chrysler legislation authorized the Chrysler Loan Guarantee Board to obtain additional compensation from Chrysler through the issuance of warrants to the government, it did not specify how many nor how the government should convert them to cash. Very few people with whom we spoke believed it appropriate for the government to retain an equity position in firms it aids. This implies, therefore, that the government should sell rather than exercise its warrants when it believes that the appropriate time to do so has arrived. These warrants could be sold either to the firm, which would retire them, or to investors.

In assistance programs for local governments, risk compensation options are limited. Warrants and other types of equity sharing are unavailable. The extent to which guarantee fees can be used is limited by the effect of decreased cash flow on a municipality's access to credit markets. But risk compensation is also not as important in municipal assistance packages because municipalities, unlike corporations, are not going to cease existing if they cannot meet their current obligations. As long as a municipality retains its tax base and its power to tax, the possibility is always present of generating the funds needed to retire the direct or guaranteed government loans.

OVERSIGHT AND ADMINISTRATION

When establishing an individual financial assistance program, the Congress must create a mechanism through which the program will be administered and overseen. The administrator's tasks include

--determining that statutory requirements are met before funds are released,

--establishing the day-to-day operating procedures for implementing the program,

--monitoring the recipient's activities throughout the program to assure compliance with covenants,

--determining the risk level of the program and the extent to which congressional goals are being met, and

--adjusting the program in response to changes in risk or in the relative importance of congressional goals.

The Congress should delegate responsibility

Although congressional oversight is important and must be provided, the Congress does not have time or the expertise to provide the necessary day-to-day program administration. In the past, the Congress has delegated that responsibility to a designated administrator or board, and it should continue to do so. At the same time, the Congress should monitor the program and the program administrator to ensure that the program continues to serve the broad outline of the national interest as defined by the congressional goals and objectives contained in the authorizing legislation. To perform its reviews, the Congress must receive adequate information from the program administrator. Usually this is done through regular oversight hearings and formal reports required by law.

Several staff members of past and present administrative boards suggested to us that an appropriate division of responsibility would have the Congress act like a corporate board of directors while the program administrator acts as its management. Thus, the Congress would set policy, and the program administrator would run the program. Past and present congressional staff members indicated that they thought the Congress should be more concerned with the decisions and operations of the administrator and its staff. But, they, too, acknowledged that the Congress did not have the time, expertise, or desire to perform the administrator's oversight and administration functions. These two views are not in serious conflict as long as the program administrator understands and implements congressional policies.

The administrator needs adequate information

To properly oversee and administer the program, the administrator must monitor the government's risk and the recipient's compliance with requirements and covenants. Risk assessment depends on the application of commercial lending principles and practices. In the early stages of previous programs, a lack of information restricted the ability of the firm's or municipality's management, the Congress, and the program administrator to intelligently determine the current or potential financial condition of the recipient. Future programs must ensure that the recipient generates the necessary information. Financial, accounting, and management information systems are crucial to the analysis of a firm's or municipality's financial condition. If the aid recipient cannot provide high quality reliable data from current systems, the recipient must be required to develop systems that will.

While sound information systems are essential, reporting requirements should not be overly burdensome. Several people we interviewed noted that providing information to the government imposes considerable costs on a distressed firm or municipality. Such an expenditure of resources and management time can cause management to focus on the needs of the oversight process as opposed to assessing the firm's or municipality's needs.

The administrator needs adequate discretionary authority

Most people we interviewed believed that an administrator's right to review and approve plans generally permits it to ensure the program serves the national interest as defined by the Congress. But, in some cases, changes in risk during a program indicated that merely controlling the overall plans and operations of an aid recipient are insufficient to ensure that congressional goals are being served. An administrator may have to demand new management, require greater concessions from beneficiaries, alter the terms of the assistance, and/or demand added collateral to secure increased direct or guaranteed loans. Similarly, significant decreases in risk may indicate that the level of risk compensation or collateral required could be lowered. The analysis and decisions on such changes depend on the factors that determined the original assistance package.

In essence, when risks increase rapidly and substantially, an administrator should either stiffen the terms of the assistance or determine that the recipient has become so risky that congressional goals and objectives do not justify further assistance. To maintain a high probability of success, the administrator(s) should have the authority to modify the level of concessions both initially and in the event that the situation changes. The Congress should grant its administrative agent the necessary flexibility to alter the aid package and negotiate new concessions as needed to control risks and assure program success. Because of its ability to enact new legislation, the Congress, of course, can also amend the aid package if necessary. Finally, it is essential that the administrator be granted the flexibility to delegate routine tasks and responsibilities.

In general, the administrators of past programs have been high level government officials with many diverse duties and responsibilities. Government departments and agencies usually have an established line of authority that permits someone to act in the principal's absence. However, this is not always true. For example, no one can act for the Chairman of the Board of Governors of the Federal Reserve System if the Chairman is unavailable. To enhance program administration, authorizing legislation should allow principals to delegate to their subordinates the review and approval of routine program actions.

Representatives of the Board of Governors told us that such a provision would improve program administration by speeding routine actions and allowing principals to concentrate on the most important administrative matters.

The administrator needs to be able to allow staff representatives to certify the approval of various transactions, plans, etc. Otherwise, the principals would be needed to close various routine transactions of the aid recipient. The principals, with the help of their designees and/or staffs, should identify those contracts, asset sales, and plans that require the principals' direct involvement. Designees and staffs should be given authority to approve those that do not.

Who should administer the program?

The program administrator could be a board, which was done in the Conrail, Lockheed, and Chrysler programs, or a single agent, as was the Secretary of the Treasury for the New York City programs. A board has the advantages of permitting a wider range of expertise and a sharing of the decisionmaking and responsibility. A single agent, on the other hand, can act more quickly and decisively.

If the Congress chooses to establish a board, it should not permit the board to be composed of representatives of the major beneficiaries of the program as initially occurred in the Conrail case. Such an arrangement delays and inhibits the necessary concessions by these constituencies. But, this does not mean the board should ignore the beneficiaries' concerns. Instead, it means that the board should balance its concerns against other aspects of the national interest.

The Congress has two basic options for determining board membership: government officials or a blue ribbon panel. A board of government officials is easier to establish because background checks and confirmations are not necessary. If the Congress believes that presidential appointees are too likely to serve the President's political interests, it can place on the board, as it has done, officials such as the Comptroller General or the Chairman of the Board of Governors of the Federal Reserve System who are likely to be more independent.

However, if the board is composed of current federal officials, they may have conflicting responsibilities. For example, during the Lockheed program, the Chairman of the Securities and Exchange Commission had to remove himself from the board because the Commission was investigating allegations of foreign bribes by Lockheed. Several of the people we interviewed thought our audit role would be compromised if the Comptroller General was directly involved in the program. Among the people with whom we spoke, opinion was divided about whether this concern implied that the Comptroller General should not sit on future boards. Those who favored the Comptroller General's participation cited our reputation for independence and its constructive role in past programs. Conflict of responsibility concerns might also be raised about the Federal Reserve Chairman because of that official's role in shaping the economy's economic performance. But most people agreed that as the nation's central banker, the Federal Reserve Chairman should serve on the board. Virtually everyone

agreed that the Secretary of Treasury should be included on future boards because of the analytic resources available within the department.

A second concern is that other high government officials may be associated with the industry in which the borrower operates. For example, the Secretary of Transportation may be evaluating the probable success of Conrail while working on deregulation policies that could help or hinder Conrail. As a result, the Secretary's responsibilities could be in conflict.

The second option is to appoint a distinguished blue ribbon panel whose members would be retired executives, respected academics, and other people who could concentrate on their panel responsibilities. But, this approach requires possibly time-consuming confirmation hearings and a need to bring these fresh panel members up to speed on the distressed firm's or municipality's problems. Furthermore, such a panel may be less familiar with the total scope of government policies and find it difficult to implement and administer the program in light of those policies.

Although the administrator(s) must make the final decisions, they generally do so only after their staffs provide them with thorough analyses of the implications of possible decisions. Thus, the staff's abilities are a crucial determinant of the quality of oversight the government provides. The staff ensures that the administrator(s) receive adequate data and analyses on which to base their decisions and that the administrators' decisions are implemented by the aided firm or municipality. This requires the staff to have a wide range of skills. It will need financial analysts, economists, and industry experts to forecast future economic conditions, evaluate risk, and determine how the government should respond to changes in risk. It will also need investment bankers and lawyers to structure deals, write necessary contracts, and review compliance. Last, it will need accountants, appraisers, and auditors to ensure that the aid recipient is correctly reporting its financial condition and truly maintaining its collateral.

As indicated in our earlier discussion of problem identification, many of these staff talents are already available in the government, particularly in the Department of Treasury and the Federal Reserve System. Financial analysts and economists are often available in other executive branch or congressional agencies. In most cases, industry specialists will have to be hired as staff or as consultants. Furthermore, government employees are less likely to have the necessary skills of investment bankers and lawyers necessary to structure deals. The government also needs access to accountants and auditors in the executive branch, our agency, and, possibly, independent accounting firms to review the recipient's financial records and determine if its collateral is secure. But, the appraisals of collateral may have to be done by consultant appraisers with the necessary expertise.

As much as possible, the administrators' staffs should be current government employees on temporary assignment to the board. This will diminish any unintended growth in federal employment. But, when this option fails, it is probably best to employ specialized staffs as consultants who can be released after their vital services are rendered.

CHAPTER 4

GUIDELINES FOR STRUCTURING, IMPLEMENTING, AND ADMINISTERING LARGE, DISCRETE FINANCIAL ASSISTANCE PROGRAMS

In the previous chapter, we reviewed the issues associated with the design and oversight of financial assistance programs for large failing firms and municipalities. The discussion focused on the importance of considerations involving:

--determination of the national interest,

--establishment of clear and nonconflicting goals and objectives, and

--protection of the government's financial interests.

In light of the historical experience with discrete large financial assistance programs and the assessment of our experience with them, we developed guidelines should the need arise to implement a similar sort of program in the future.

This guidance provides a framework for the Congress and those responsible for program administration to use in structuring, implementing, and overseeing such programs. While the guidelines should not be construed as legislative or administrative recommendations, they should be viewed as fundamental requirements for appropriate program design. Appropriate design, however, is not enough to ensure program success. The history of past programs suggests that good ideas alone are not enough. In these programs, many very capable people worked very hard, and a sim larly high level of expertise and effort will be necessary for future programs to succeed.

--Before creating a discrete assistance package, the Congress should determine (1) whether a prospective recipient's financial problems are its alone or part of broader industrywide or regional problems and (2) whether a legislative solution will serve the national interest better than allowing market forces and established judicial procedures to proceed.

--The government should use commercial lending principles and practices as much as possible (1) to perform the financial analyses necessary to determine whether a discrete aid program best serves the national interest, and (2) to structure the program to accomplish congressional goals and objectives while protecting the government's financial interest.

--The government should use its assessment of a recipient's financial condition to determine the amount of federal aid needed, changes that must be made in existing contracts, and the amount of time before repayment is required.

--To ensure that program administrators understand congressional intent, the Congress should include in the authorizing legislation a clear and concise statement of its purpose, goals and objectives, and standards by which success in meeting those goals and objectives can be measured.

--To accomplish its aims, the Congress should ensure that legislated and administratively determined requirements further the attainment of its goals and objectives.

--The Congress should avoid establishing conflicting goals and objectives as much as possible as well as requirements that are unnecessary to the program and provide guidance on the types of trades-offs the Congress prefers program administrators to make among conflicts that remain.

--In attaching conditions to an assistance program, the government should keep in mind that the affected parties will cooperate only if the program offers a better alternative than bankruptcy or liquidation.

--To reduce the government's risk exposure, to help the program appear fair, and to create the appropriate incentives for the beneficiaries with a stake in the financial success of the borrower, the government should limit the amount of aid it must provide as part of an assistance package by requiring that the beneficiaries of such aid also make financial contributions.

--The extent of the concessions the government obtains from a group of beneficiaries should depend on the costs to the government of obtaining the concessions, the value of the concessions to the program, and the costs of the concessions and the value of the assistance program to the beneficiaries.

--To reduce the government's risk exposure, the Congress should require government approval of an aid recipient's financial and operating plans and new major contracts.

--At the same time, to ensure that program administrators do not get overly involved in managing the recipient's operations, the Congress should establish criteria for determining which contracts and plans should be reviewed.

--When the government rejects a proposed plan or contract because it is too risky, it should require management to make changes and resubmit the proposal, but the government should not attempt to develop its own plans and impose them on management.

--To reduce the risk, the Congress should ensure that the government's financial interest is secured. In this regard, it should require that the aid recipient maintain adequate collateral and that all other lenders subordinate their claims on this collateral to the government's. For loans to a municipality, however, collateral is probably unobtainable.

--The Congress should require that the government receive some risk (financial) compensation in return for providing federal aid, particularly if the program succeeds in restoring the recipient's financial health.

--In deciding how much risk compensation to obtain, the government should balance the need to create appropriate incentives and maintain an appearance of being even-handed against possibly delaying the assisted firm's or municipality's ability to obtain unassisted access to capital markets or weakening its ability to recover.

--To properly oversee and administer a program, the Congress should establish, as part of each program, an administrative mechanism to monitor the government's risk and the recipient's compliance with government requirements, and the program administrator should have authority to adjust a program as risks change or circumstances warrant.

AGENCY COMMENTS AND GAO EVALUATION

We received comments on a draft version of this report from the Departments of the Treasury, Transportation, and Commerce; the Office of Management and Budget (OMB); and the Board of Governors of the Federal Reserve System. Although several agencies, referred to our recommendations in their comments, the draft report contained no recommendations.

Treasury said that it appreciated having the benefit of our research in this area because it is considering many of the issues we address in this report. It had no substantive comments on the report's contents. Transportation said that it believes the report draws very straightforward and reasonable conclusions, and it has no objections to our conclusions and recommendations.

Commerce questioned the necessity of preparing guidelines for federal rescues of failing firms and municipalities because the Administration does not believe that federal intervention is either necessary or efficient except for very limited and well established purposes. Commerce believes that by developing guidelines we are signaling firms and municipalities that federal aid is inevitable and encouraging them to look to the federal government for assistance. Commerce also believes that the

report reaches policy conclusions without adequately developing important concepts, such as the definition of a failing firm. Commerce also believes that the report does not adequately analyze what would have happened in past situations if no aid had been provided. Commerce asks, for example, how one might know whether, in the long run, net employment is greater with the aid programs than without them.

We believe that the guidance presented in this report is very important because the circumstances that have led the Congress to rescue financially troubled firms and municipalities in the past are likely to recur. If, under those circumstances, the Congress were to design an aid program similar to those it created in the past, the probability of success for that program would be enhanced if the Congress followed the guidelines in this report for design, administration and oversight of such programs. We do not believe that by providing guidelines we are advocating federal intervention or telling the Congress when to provide aid. That is a policy decision appropriately left to the Congress. Nor do we believe that we are encouraging firms and municipalities to seek such assistance from the federal government. Instead, we believe that the requirements on recipients that our guidelines suggest might discourage rather than encourage firms and muncipalities from seeking federal aid.

We do not agree with Commerce that the report does not sufficiently develop important concepts. In the particular case Commerce mentioned, we believe that in the context of the report it is clear that a "failing" firm or municipality refers to one that faces impending bankruptcy unless a major workout or reorganization occurs, with or without federal participation. We also believe that we adequately discuss what might happen to financially distressed firms if federal aid is not provided. For example, we discuss how workouts might happen to forestall bankruptcy and that bankruptcy need not imply the immediate cessation of production. We agree with Commerce that bankruptcy can sometimes improve economic efficiency by reallocating resources into more productive uses, and that we do not know if, in the long run, net employment has been greater with the previous federal assistance programs, than it would have been without them. We question whether anyone could accurately make that determination and, in any event, such an effort was outside the scope of this review. In addition, even if one found that government aid did not increase net employment, one must also recognize that the Congress often had many goals and objectives, not all of which were economic, for each program it authorized.

Commerce also suggested that we add two guidelines. First, Commerce suggested saying that the government should make sure that a potential aid recipient has exhausted all potential private sources of financing before seeking aid. A determination that credit is not available elsewhere has been a criterion for release of government funds to recipients in previous programs and we have no quarrel with that practice. However, we do not

share Commerce's concern that borrowers will not look thoroughly for private financing before approaching the government for aid. Experience with past programs suggests that potential aid recipients considered government aid as a last resort and sought it only when private credit sources became unavailable to them. We have no reason to believe this will not be true in the future.

Second, Commerce suggests saying that before providing aid the government should explore whether antitrust laws have prevented a failing firm from surviving, such as through merger, and, where appropriate, remove any impediments to merger. We agree that this is one of many considerations that could be addressed in identifying the problems faced by a failing firm, as envisioned in our first guideline.

Both OMB and the Federal Reserve recognized our efforts to provide a balanced discussion and not judge the appropriateness of federal rescues of failing firms and municipalities. However, both agencies suggested that those efforts could be enhanced by changes in the report that would make federal aid seem like a less desirable policy option than they believed our draft report implied.

The Federal Reserve suggested that our draft report minimized the disadvantages of providing federal aid. It believed that we should say more about possible adverse effects of providing aid that should be evaluated in conjunction with the national interest concerns used to justify government intervention when determining whether a particular program is in the national interest. We agree that our draft version did not adequately address possible adverse effects of providing aid, and we have added a discussion of this issue to our final report. (See p. 28.)

OMB stated that our guidelines should say explicitly that the government should not consider intervening unless market failure has occurred. They define market failure to be "the existence of regulatory, administrative or similar impediments that prevent private parties from efficiently reorganizing or liquidating a failing company." This definition differs from the conventional use of the term to describe a market in which the actual level of production or consumption will differ from society's optimal level because those making the production or consumption decisions will not take into account benefits or costs of production or consumption that accrue to others. With respect to either definition, we do not agree that the government's decision to provide financial aid should depend entirely on a demonstration of market failure. For rescues of financially troubled municipalities, in particular, demonstrating market failure is unlikely to be a sound basis for deciding whether to intervene. In determining whether a legislative solution serves the national interest, the Congress should compare the anticipated costs, benefits, and consequences if assistance is offered with expectations of what would occur if market forces and established legal procedures are allowed to operate.

OMB suggested that in our report we should examine the utility of bankruptcy laws in rescuing and reorganizing financially troubled firms. We recognize that bankruptcy might be a viable alternative to government assistance in some situations. On the other hand, no corporation the size of Chrysler has gone through a liquidation proceeding, and a municipal bankruptcy is not likely to forestall large federal outlays to assure that vital services are maintained. A more in-depth discussion of the bankruptcy option than what is provided in chapters 1 and 3 of this report would be outside the scope of this report, which focuses primarily on how one designs, oversees, and administers financial assistance programs when the government chooses to provide aid.

We agree with OMB's view that financially troubled firms or municipalities might avoid difficult cost-cutting steps if they believe that federal aid is readily available and not onerous. As these programs evolved, the government, in fact, stiffened the requirements on both the recipients and other beneficiaries and imposed numerous restrictions on managements' decisionmaking authority. Many of the guidelines we propose, particularly those related to approval of plans and contracts, concessions, and risk compensation, urge that similarly stiff requirements be part of any future program.

OMB suggested three additional guidelines that it believed were conditions of the Chrysler program: the right to fire or refuse to hire a recipient's management, the right to inspect a recipient's books and records, and the right to require sale of profitable subsidiaries. (The government's authority was not quite as strong as indicated by OMB's comment.)

We agree with OMB that the government may need the authority to replace management, or demand other new concessions, as the level of risk changes during the life of a program (see pp. 54 to 55). The government had the authority to replace management in the Lockheed program. Adoption of our final guideline would imply that future program administrators would also have this authority, except that such authority may not be applicable when the recipient is a municipality. We do not believe, however, that the government should have the authority to select new management. Such authority would imply a level of government involvement not contemplated by our guidelines. Even when the government exercises its authority to replace management, it should leave the choice of new management to the aid recipient, retaining only the right to disapprove. This limitation on authority would be consistent with our guideline that the government not be overly involved in managing a recipient's operations.

We agree with OMB that the government should have the right to review and inspect fully the books and records of an aid recipient. We believe that such authority is a part of at least 11 of the 16 guideline presented on pages 56 through 58.

While we strongly support beneficiary concessions, we disagree with OMB's suggestion that the government have the authority to force an aid recipient to sell off profitable subsidiaries or affiliates to avoid cross-subsidizing failing operations. We believe that the aid recipient should decide which assets to keep and which to sell (subject to government approval), not the government. The need for immediate cash to remain a going concern is very important, but long-term viability is important also. Forcing the sale of profitable operations may reduce the cash flow necessary to maintain long-term viability. We anticipate that the recipient's management is better equipped than the government to evaluate the trade-offs implied in asset sale decisions.

The Federal Reserve suggested that our report could devote more attention to the problems of administering aid programs because administration is not only critical to a program's success or failure but also extremely time-consuming and complex. We agree that administration is critical, complex, and time-consuming, and in providing guidance on administration and oversight we do not mean to minimize the practical difficulties of applying our guidelines to actual decisionmaking. We believe that the report provides sufficient attention to administration and oversight on pages 50 through 55.

The Federal Reserve expressed concern with our guideline that "the government should keep in mind that the affected parties will cooperate only if the program offers a better alternative than bankruptcy or liquidation." Although the Federal Reserve recognized that a failing firm or municipality will consider its alternatives before soliciting federal aid, the agency believes that once the beneficiary has received that aid, its compliance with the conditions of the aid is essential if it wishes to continue to receive aid. The Federal Reserve suggested that authorizing legislation specify sanctions the government can use to secure compliance. We do not believe that the government can secure compliance once it has given the recipient aid if the recipient determines that noncompliance is a superior alternative, particularly if repeated drawdowns of authorized funds are unlikely. On the other hand, sanctions for noncompliance can be useful in inducing recipients to comply. The most powerful sanction the government can apply is to declare the recipient in default and initiate foreclosure proceedings. But even the threat of foreclosure cannot force a recipient to comply when it believes that continued compliance is worse than default. Furthermore, the threat of foreclosure may be weak if the recipient judges that the government will be reluctant to apply it. Many people with whom we spoke believed, in general, that the government might better be able to deter small violations of the conditions agreed to in the aid package if less severe sanctions were also available. But since applying any such sanctions, such as a fine or an increase in a guarantee fee, might weaken the recipient's ability to repay its assistance, we found no strong support for any specific sanction.

In addition to providing us general observations, the Federal Reserve also suggested some specific changes that it believed would improve our report. In response to these suggestions we revised our report in the following ways:

--We clarified that our guideline calling for the Congress to establish an administrative mechanism referred to a specific mechanism for overseeing each aid program and not a perpetual mechanism. (See p. 58.)

--We clarified in our introductory paragraph that in some past programs the federal government participated as a guarantor rather than as a lender. (See p. 1.)

--We clarified our discussion of the importance of commercial lending principles and practices to show that we recognize that they should be relied on only to the extent that they are consistent with congressional intent. (See p. 7.)

--We added language stating that before approving aid, the Chrysler Loan Guarantee Board needed to determine that there was a reasonable prospect that Chrysler could remain viable after 3 years without further government aid and that Chrysler would be able to repay its government-guaranteed loans by 1990. (See p. 16.)

--We revised our description of the Chrysler Loan Guarantee Board's authority to adjust legislated concession requirements to say that the Board made such adjustments while avoiding making any legal interpretation about how much flexibility the Board had. We agree with the Federal Reserve that in future programs, administrators should have such flexibility. (See p. 16.)

--We clarified the report to show that the Chrysler Agreement to Guarantee was between Chrysler and the government. (See p. 16.)

--We clarified our description of the restructuring Chrysler underwent to show that although it was fairly quick, it was painful. (See p. 17.)

--We revised our summary table at the end of chapter 2 to reflect more accurately (1) the authority the Chrysler Loan Guarantee Board had to obtain from Chrysler compensation for risk and (2) the total dollar value of concessions required before Chrysler could receive any federal aid (see pp. 19 and 20.)

--We accepted the Federal Reserve's suggested revised language concerning lenders' preferences for workouts rather than bankruptcies. (See p. 39)

--We clarified our discussion of the congressional role in legislating concessions to say that when Congress legislates specific concessions, the legislative language should allow the agent overseeing the program some discretion in the negotiating process. (See p. 44.)

--We added language to acknowledge that allowing program administrators the flexibility to delegate some of their review and approval functions to designated high-level officials in their agencies will enhance program administration. (See pp. 52 and 53.)

We agree with the Federal Reserve that concessions can take the form of required new financing as well as changes in existing arrangements. Since we make this point on page 41, we have not elsewhere specified that concessions or financial contributions can include new financing.

The Federal Reserve suggested a specified contract value as the most workable criterion for determining the need for government approval or disapproval of an aid recipient's contracts. Although we do not disagree, we think it is important to add that the dollar value chosen should be based on a financial evaluation of the recipient. Some people believe that in the Chrysler program, the value was set too low.

In general, the Federal Reserve agrees with us that the government should receive compensation for the risk it assumes in providing aid. We recognize that obtaining full compensation through guarantee fees is probably not feasible and we agree that equity participation in some form by the government is often justified. Although the government should always obtain some risk compensation, the amount obtained must be balanced against other congressional goals, such as speeding the recipient's unassisted access to capital markets. We believe that although equity participation is often appropriate, the decision to include it, as a program feature as well as its extent and form, should be made on a case-by-case basis.

The Federal Reserve does not entirely agree with one distinction we draw between one-time rescues, such as the Chrysler, Lockheed, and New York programs, and traditional federal credit assistance programs. It questions our statement that in the one-time programs no basis exists for estimating the probability of default and no way of scientifically estimating possible losses. Its concern is that this statement should not be interpreted to mean that program administrators should not make their best judgment regarding a potential recipient's prospects for repayment. We agree with the Federal Reserve that to make these judgments intelligently, administrators and the Congress must have adequate information on the financial condition of the potential recipient and they must use commercial lending principles and practices to analyze this information (see, for example, p. 24 and p. 29).

The statement that the Federal Reserve questioned is intended to show that these one-time programs, unlike many of the traditional ones, do not have large loan portfolios and years of experience on which one can actuarially base default probabilities and loss estimates. (See p. 2.)

The Federal Reserve suggested, and we agree, that the possibility of liquidation if no aid is provided is only one factor that the government should consider in deciding whether to extend aid. In particular, the Federal Reserve expressed concern that government aid might interfere with the working of the market whereby firms that remain in an industry tend to claim the market share lost by a firm forced to liquidate after entering bankruptcy. The Federal Reserve believes that the government must consider this possibility in deciding whether to provide aid. We agree, in general, that this possibility should be considered, but we are less sure than the Federal Reserve about what would have happened to Chrysler's market share, and the implication for the national interest, if Chrysler had been liquidated. When Chrysler was near bankruptcy, different analysts expressed a variety of opinions about the extent to which auto production would have been depressed following a Chrysler liquidation. One of the national interest concerns advanced in the debate about aiding Chrysler was the need to prevent further market penetration by foreign, particularly Japanese, automobile companies.

The Federal Reserve disagreed with our statement that the government should not seek concessions from suppliers other than those for whom the distressed firm or municipality is their main or only customer. We agree with the Federal Reserve that fairness suggests that all beneficiaries of an aid program should make concessions. However, cost must also be considered. A large firm or municipality almost certainly will have a large number of suppliers and the government will have very little, if any, leverage over those that do not heavily depend on sales to the potential aid recipient. The amount of concessions these suppliers will agree to make will be limited by their expected gains from a recovery by the distressed firm or municipality. When these expected gains are small, the concessions will be small and may easily be outweighed by the cost to the government of obtaining them. Government efforts can be better directed by pursuing those who have a major stake in the distressed firm's or municipality's financial recovery. (See p. 43.)

The Federal Reserve suggested that we not include nationalization as an option for providing government assistance on page 35. We believe that completeness requires its inclusion. In doing so, we take no position on its desirability.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF THE GENERAL COUNSEL

November 10, 1983

The Honorable William J. Anderson
Director
United States General Accounting Office
General Government Division
Washington, D.C. 20548

Dear Mr. Anderson:

Chairman Volcker has asked me to respond to your request for the Board's comments on the General Accounting Office's (GAO) Draft Report entitled "Guidelines for Rescuing Large Failing Firms & Municipalities" (Report). The GAO should be commended for undertaking this complex task, so my comments and recommendations are offered with the hope that they will constructively assist your efforts.

I would first like to offer some very general observations and then follow with specific comments and recommendations. First, the Report states that the GAO does not, by issuing the Report, "judge whether past or future [federal assistance] programs are, or will be, an appropriate policy response to the impending failure of a large firm or municipality." (page iii) A review of the entire Report, however, leads the reader to believe that such programs are an appropriate response because the advantages of such programs are discussed throughout the Report while the disadvantages and attendant problems are either minimized or not discussed at all. Additional discussion of the actual disadvantages and problems associated with past programs would greatly benefit future policy makers, and provide a more balanced presentation in my view.

Closely related to this first observation is a second observation that the Report adequately addresses the possible adverse outcomes of <u>not</u> providing federal assistance, but that it provides very limited analysis of the possible adverse outcomes of actually providing aid. Additional discussion of these possible adverse outcomes would be very useful, e.g., the effects on other firms in the industry (by strengthening the weakest firm, other stronger firms may be weakened), the possible erosion of market discipline, the federal resources (both human and monetary) which are diverted from other issues of equal or greater national importance, and similar economic and policy concerns.

Third, the Report devotes sufficient attention to the Congressional decision to authorize a federal assistance program, but devotes less attention to the actual administration of the program once it has been Congressionally authorized. Our experience as a member of the Chrysler Corporation Loan Guarantee Board has convinced us that the administration and oversight of a federal aid program is not only critical to the program's success or failure, it is also extremely complex, requiring untold time and efforts of the program administrators and their staffs and consultants. More discussion of the complex process involved in past programs of gathering and analyzing periodic reports on the recipient's financial condition and prospects, negotiating new or revised concessions from affected parties, determining whether the recipients' operating and financing plans continue to meet required criteria, etc. could be very beneficial to future Congresses and program administrators. Particular attention could be focused on the very real problem of ensuring that the program serves and protects the government's interest while avoiding the undue involvement in the day-to-day management of the aid recipient.

Fourth, throughout the Report the premise is stated that in attaching conditions to an assistance program, "the government should keep in mind that the affected parties will cooperate only if the program offers a better alternative than bankruptcy or liquidation" (pgs. 40 and 57). This premise undercuts the federal government's leverage in our view. This premise may be more applicable to an aid recipient's creditors and other beneficiaries, but we believe that is a faulty premise with respect to the failing corporation or municipality. Of course, the failing entity will consider all of its alternatives, such as commercial workouts, reorganization or liquidation in bankruptcy, before soliciting federal aid. Once it has received that aid, however, its cooperation and compliance with conditions attached to that aid is essential if it wishes to continue to receive aid. It is our view that, because the federal government has so much at risk in aiding a failing corporation or municipality, the program's legislation should contain sanctions available to the Government to secure compliance with the conditions attached to such aid. Therefore, we recommend that the premise discussed above be modified consistent with these principles.

-3-

Attached to this letter are more detailed comments and recommendations (Attachment A). I hope that my comments and general observations will be of assistance to you. Please let me know if we may assist you further on this most important task.

Sincerely,

Michael Bradfield

Attachment

MB/TRH:khc

GAO Note: Page numbers have been changed to correspond to the final report.

Attachment A

Page 57 We recommend that the fifth paragraph be modified to clarify that beneficiaries of government aid may be required to make financial contributions which take the form not only of concessions in existing arrangements but also new financing as well. "Concessions" may be interpreted as affecting only debts already extended, so Congress should specify whether new loans or credits should be required as was done in the "Chrysler Corporation Loan Guarantee Act of 1979 (CCLGA)."

We agree with the concept, contained in the eighth paragraph, that the program administrators should not get overly involved in managing the recipient's operations and that Congress should establish criteria for determining which contracts and plans should be reviewed. In deciding which contracts should be reviewed, we believe that the most workable criteria is an aggregate value criteria. For example, the CCLGA required the Loan Guarantee Board (Board) to review contracts having an aggregate value of $10,000,000 or more. This kind of dollar criterion is easily administered and generally provides a good measure of the level of contracts which should require review.

With respect to operating and financing plans, the authorizing legislation should specify what plans shall be prepared by the recipient. However, the Board should be given the flexibility to impose both specific requirements on the contents of the plans and sanctions on noncompliance with such requirements. The individual members of the Board should also be given the flexibility to delegate the review and approval of such contracts or plans as they deem reasonable to designated high-level officials in their respective agencies. This flexibility will allow the individual members to delegate review of those contracts or plans which technically meet the criteria requiring review, but which are not significant enough to demand direct review by the individual Board member. This authority to delegate would permit the individual Board members to devote their time to the more pressing needs of the program.

-2-

Page 56 We agree that the government should receive compensation for the risk it assumes in providing aid. We suggest, however, that the second paragraph be modified to recommend that Congress specifically authorize the Board to secure for the government an equity position in the recipient corporation, including the taking of warrants, so that the government can participate in the gains, if any, of such corporation. Allowing equity participation is justified as deferred compensation for risk.

Page 58 It is not entirely clear whether the last recommendation suggests that Congress establish an "administrative mechanism" to oversee a particular federal aid program, or if it suggests that a perpetual mechanism be established to oversee all possible Congressionally-authorized federal aid programs. Therefore, we recommend that Page 58 be modified to clarify that this administrative mechanism should exist only so long as any loan guaranteed pursuant to the specific authorizing legislation remains outstanding. In our view, a perpetual "administrative mechanism" is not in the national interest, not only because of the increased costs involved in maintaining such a structure, but also because such a mechanism may not be able to respond as effectively to the type entity which has sought federal aid. In other words, the type of entity -- the nature of its business, its size, etc. -- seeking financial aid will necessarily dictate the expertise required to evaluate and administer any Congressionally-approved federal assistance program. A perpetual administrative mechanism may also signify to companies and municipalities that the government will rescue them when they encounter adverse conditions. This false signal may, in turn, encourage imprudent management or excessive risk-taking. A perpetual administrative mechanism is counter to our belief that government financial assistance should occur in only very limited circumstances.

Page 1 The first paragraph should be modified to reflect that cash infusions were provided to the Lockheed Aircraft Corporation through loan <u>guarantees</u> rather than through loans.

GAO NOTE: Although the Federal Reserve referred to a recommendation, the draft report contained no recommendations.

Page 2 The first paragraph provides that, because the Lockheed, Chrysler, or New York City programs were one-time programs, there existed no basis for estimating the probability of default and, further, there existed no means of scientifically estimating possible losses. We cannot entirely agree with this premise. We agree that commercial principles of credit risk analysis cannot be solely relied upon because this might thwart Congressional intent: aid recipients are not usually financially healthy enough to merit additional credit extensions under normal commercial principles. However, the program administrators should have resources adequate to analyze the financial and operating plans of the potential recipient, utilize commercial principles of credit risk analysis (tempered by recognition of Congressional intent), and exercise their judgment regarding the prospect for repayment of any loans. We, therefore, recommend that lines 6-9 be amended consistent with these principles.

Page 3 We agree with the conclusion that Chrysler probably would have been liquidated had it filed or been forced to file bankruptcy. However, that conclusion is not complete without an attendant recognition that, in all likelihood, market forces would have reacted by claiming the market share formerly held by Chrysler. The possibility of liquidation, without aid, is only one factor that the Government should consider in deciding whether to extend aid, because, otherwise, it may interfere with natural market forces without real benefits to the national interest. We suggest that these principles be included in the discussion on bankruptcy at pages 2 to 3 ..

Page 5 We agree with the Report's conclusion that a Reconstruction Finance Corporation (RFC)-type agency would not be an efficient or effective way to provide aid to individual firms and municipalities facing financial collapse. For the reasons discussed on page 2 herein, we do not support the formation of a continuing "administrative mechanism," such as a RFC-type agency.

Page 7 We agree with the conclusion that commercial lending principles and practices are crucial in designing assistance programs. However, this discussion should be expanded to suggest that such

principles must be considered in conjunction with Congressional intent, because a consideration of only commercial principles in the case of Chrysler would have resulted in a decision not to grant aid. Our recommendation could be accomplished simply by modifying the discussion to acknowledge the importance of commercial lending practices and principles but cautioning that such principles and practices must be tempered by a recognition of Congressional intent and the national interest.

Page 16 We recommend that the discussion regarding the findings which the Chrysler Loan Guarantee Board was required to make before granting any guarantees to Chrysler be expanded so that future policy makers which rely on this Report will better understand that extensive findings, including findings on conditions established by the Guarantee Board, were required in order to protect the national interest. The Chrysler Corporation Loan Guarantee Act of 1979 provided that a loan guarantee could be extended only pursuant to a commitment which had been issued on the basis of eight findings found in Section 4 of the Act. Section 5 of the Act, in turn, required that the commitment provide that the actual loan guarantee would be issued only if at the time of issuance the Board found that (1) credit was not otherwise available to the corporation; (2) there existed reasonable assurance of repayment of the guaranteed loan; (3) the loan carried a reasonable rate of interest; (4) the operating and financing plans met the requirements of the Act; (5) the corporation was in compliance with the plans; (6) the Board was reasonably assured that the plans were feasible; (7) the Corporation would provide required updates of the plans and performance reviews during the life of the guarantee; (8) the Corporation was not substantially likely to be merged with any foreign entity; and (9) the Corporation was in compliance with the commitment terms imposed by the Board.

In addition to these findings, the Chrysler Review Board also imposed some 26-27 additional conditions in the terms of the commitment to issue the guarantees, each of which had to be satisfied at the time a guarantee was issued. These conditions, whether imposed by statute or by the Board, focused not only on the basic issue of whether Chrysler was an economically viable operation, as the Report suggests, but also on

-5-

whether there was a reasonable prospect of Chrysler remaining a going concern three years hence (1983) and beyond, such that the potential contribution of Chrysler to the economy justified the risks to the taxpayers.

Page 16 We recommend that the fifth full sentence in paragraph 2 be revised to read as follows:

> Specific amounts of non-federally guaranteed assistance in each of these categories were suggested by the Act, although the individual elements of concessions were adjusted by the Board.

As revised, this sentence would make a statement of fact and thus avoid any legal interpretations of the Act. However, consideration should be given to recommending that the authorizing legislation specify that the review board has the flexibility to adjust the individual elements of concessions provided that the total required amount of non-federally guaranteed assistance is met. This will avoid any questions regarding the extent of the Board's flexibility in this area.

Page 16 We recommend that the phrase "and the banks," appearing in line 41, be struck since the banks were not a party to the Chrysler Agreement to Guarantee.

Page 17 We cannot fully endorse the statement that the Chrysler "restructuring took place fairly quickly with less interruption of the firm's operations than would have occurred in a bankruptcy." Chrysler's painful process of rehabilitation is understated in our view and does not acknowledge the major operational interruptions experienced by Chrysler, i.e., a substantial number of employees were dismissed, a major revision in operational and marketing strategies was made, major union contract concessions were obtained and other similar economic and personal sacrifices were required.

Page 19 This table states that the Chrysler Corporation Loan Guarantee Act of 1979 authorized the Board to charge an additional fee and obtain warrants to compensate for risk. We recommend that this be revised to state more generally that the Board was authorized to collect an additional fee and enter into contracts whereby the Government participated

in the corporation's gains. By tracking more closely the Act's authorization, it is made clear that the Board's authority was broader than obtaining warrants to compensate for risk.

Page 20 The figure of $1.4 billion in the Chrysler column should be corrected to read $2.0 billion.

Section 4 of the Chrysler Corporation Loan Guarantee Act of 1979 conditioned a commitment to guarantee, among other things, on existence of non-federally guaranteed assistance of at least $1.43 billion. In addition, Section 6 of the Act conditioned the issuance of the loan guarantee on the existence of a reduction of wages and benefits to employees represented by unions by at least $462.5 million and to nonunion employees by at least $125 million. Therefore, the Act required federal assistance to be matched by concessions of $2.0175 billion.

Page 35 This section alludes to the options available to Congress in choosing the form of assistance once a decision has been made to provide governmental assistance, and suggests nationalization is one option available. We strongly oppose such an option being considered, and recommend that this option be deleted from the Report.

Page 39 We question the conclusion that "lenders prefer workouts . . ." because that preference will often be dictated by whether the lender is secured or unsecured, and if secured, the relative leverage of the secured lender's position vis-a-vis other secured lenders. Perhaps this statement could read "Workouts may be preferred by lenders, especially when the value of any collateral is insufficient to cover debts."

Page 43 We disagree with the conclusion that concessions should not be sought from suppliers who do not depend on the recipient, i.e., the recipient is not the supplier's primary or critical customer. Instead, we believe all beneficiaries should participate on a fair and equitable basis in any required concessions. We would agree that the degree of concessions might be greater from those creditors who have the greatest stake in the company's survival, however, no class of creditor beneficiaries should be completely ruled out as candidates for concessions.

Page 44 — We do not agree entirely that concessions should be legislated. We would, however, agree that Congress should establish the aggregate amount of required concessions, as was done in the Chrysler Corporation Loan Guarantee Act, and then provide the Review Board the flexibility to determine whether components of the aggregate amount are reasonable. Otherwise, if the components are legislated, the program may fail for lack of the ability to negotiate each of the components.

Page 58 — We suggest that another guideline be added or that the last guideline be expanded to suggest that Congress also establish sanctions for a recipient's noncompliance with loan guarantee program requirements. Otherwise, the Government's only available sanction -- refusal to grant additional guarantees -- may not be a viable sanction, i.e., the aid recipient may gain leverage by refusing to comply, knowing that the Review Board is not willing to impose its only available sanction because of the impact on prior guarantees and the public interest in general.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

NOV 1 4 1983

Mr. William J. Anderson, Director
General Government Division
U. S. General Accounting Office
441 G Street, N.W.
Washington, D. C. 20548

Dear Mr. Anderson:

The Office of Management and Budget recognizes the efforts of the General Accounting Office to provide a balanced discussion in the draft GAO report, Guidelines for Rescuing Large Firms and Municipalities, Code 971903. However, OMB proposes several changes in the guidelines in order to incorporate principles and policy objectives not properly dealt with in the report.

The GAO report should make clear that the option of government intervention should not be considered unless market failure can be demonstrated. Market failure does not mean that a firm or industry is losing money or on the verge of bankruptcy, but rather implies the existence of regulatory, administrative or similar impediments that prevent private parties from efficiently reorganizing or liquidating a failing company. Examples of such market failure would be anti-trust regulations that prevent a failing firm from being acquired, or certain flaws or inflexibilities of the bankruptcy laws.

In this regard, it would be helpful for the GAO report to examine the utility of the bankruptcy laws as an efficient mechanism to rescue and reorganize financially troubled firms. As the report notes, workouts under the bankruptcy laws might have occurred in the prior instances where the federal government has provided assistance.

In addition, the report should explicitly recognize that government assistance to failing firms results in social costs. For example, a municipality or company will be less willing to face up to needed, but perhaps difficult, cost-cutting efficiency measures if federal assistance is perceived as a readily available and not particularly onerous alternative. As a result, the cost-cutting measures will be avoided and inefficient activities will be continued.

If both the above points are added to the report, then it will be made clear that government assistance to failing firms is a policy that is generally to be avoided.

With respect to the report's specific guidelines, OMB agrees that the government should not attempt to develop specific business plans and impose them on management. Further, OMB agrees that Congress should require aid recipients to maintain adequate collateral, that other lenders subordinate their claim on this collateral to the government, and that the government should receive some risk (financial) compensation in return for providing federal aid.

However, the guidelines fail to mention several other conditions that were imposed in the Chrysler case and which OMB believes are extremely desirable:

- The government should have the right to fire or refuse to hire an aid recipient's management.
- The government should have the right to review and inspect fully the books and records of an aid recipient.
- The government should have the right to require an aid recipient to sell off profitable subsidiaries or affiliates so as not to cross-subsidize failing operations.

These additional measures are not only essential for sound management and oversight, but also because they will force corporate management to balance its loss of autonomy against the value of government assistance. Such restrictions are essential if the social costs inherent in a policy of government assistance are to be minimized. OMB believes that, absent such measures, troubled enterprises will be overly quick to come to the government for financial assistance.

In summary, the GAO guidelines should state that the government will not consider providing financial assistance until market failure can be demonstrated. Only if this condition is met should government assistance be contemplated.

Sincerely,

Joseph R. Wright
Deputy Director

APPENDIX III

UNITED STA... DEPARTMENT OF COMMERCE
The Assistant Secretary for Administration
Washington, D.C. 20230

DEC 12 1983

Mr. J. Dexter Peach
Director
United States General
Accounting Office
Washington, D.C. 20548

Dear Mr. Peach:

This is in reply to GAO's letter of October 11, 1983, requesting comments on the draft report entitled "Guidelines for Rescuing Large Failing Firms and Municipalities."

We have reviewed the enclosed comments of the Under Secretary for Economic Affairs and believe they are responsive to the matters discussed in the report.

Sincerely,

Kay Bulow for

Arlene Triplett
Assistant Secretary
for Administration

Enclosure

UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for Economic Affairs
Washington, D.C. 20230

Mr. J. Dexter Peach
Director
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Peach:

We have been asked to review and comment on the draft General Accounting Office (GAO) report "Guidelines for Rescuing Large Failing Firms and Municipalities". At the outset, we would like to make it clear that the subject of the report -- government intervention in the economy -- is at odds with this Administration's basic policy approach. The Administration does not subscribe to the view that, except for very limited and well established purposes, government intervention in the economy is necessary or efficient.

Given our perspective on the issue, we first question the necessity of preparing a report of this nature. A purely descriptive report, which discusses past experiences and identifies specific elements of various aid packages that enhance their chances of success, may be useful. However, developing policy guidelines, as this report does, leaves the impression that such aid is inevitable and encourages firms and municipalities to look to the government for assistance. We should not send this type of signal to firms and municipalities.

Second, the report too often fails to develop fully concepts fundamental to its argument. For example, the notion of a "failing" firm or municipality is certainly a critical concept in the paper, but nowhere in the paper is the idea of "failing" discussed. In fact, the terms "failing" and "troubled" are often used interchangeably, neither of which would have the same meaning in the Conrail, Lockheed, or Chrysler examples.

Third, the report repeatedly draws policy inferences or reaches conclusions that are not directly linked to the analysis of the report. There is never any thought given to what would have happened if no Federal aid had been provided in the cases examined. For example, how do we know that, in the long term, net employment is greater with these aid programs than without them? In the long run, it could be argued, domestic resources might have been used more efficiently if Chrysler's resources and output had been absorbed by the rest of industry, allowing resources to move to their highest and best use. The report fails to acknowledge much less discuss these issues. As a result, the report's policy conclusions and inferences may be incorrect or misleading.

-2-

Two additional points that could be added to the GAO guidelines that relate to large firms are the following:

(a) The government should make every effort to determine if the potential recipient of government aid has exhausted all private financial sources before seeking aid. A government guaranteed loan is obviously a better buy despite the restrictions imposed, so there may not be sufficient pressure on the part of the borrower to look into every corner of the money and capital markets.

(b) A merger for the troubled firm may obviate or reduce the need for direct assistance from the government. Congress and the Executive branch should explore the extent, if any, to which the antitrust laws impede a failing firm's ability to survive, such as its ability to find a merger partner, and take appropriate corrective action.

Thank you for the opportunity to comment on the draft report.

Sincerely,

Frederick T. Knickerbocker (for)

Under Secretary for Economic Affairs

U.S. Department of Transportation

Assistant Secretary
for Administration

Mr. J. Dexter Peach
Director, Resources, Community
and Economic Development Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Peach:

We have enclosed two copies of the Department of Transportation's (DOT) reply to the General Accounting Office (GAO) draft report, " Guidelines for Rescuing Large Failing Firms and Municipalities," dated October 11, 1983.

As indicated in our position statement, DOT has no objection to the conclusions and recommendations of the GAO report. We believe the report draws very straightforward and reasonable conclusions supporting the need for criteria governing future financial assistance programs for distressed firms and municipalities.

If we can further assist you, please let us know.

Sincerely,

Jon H. Seymour
for Robert L. Fairman

Enclosures

GAO Notes: Although DOT referred to recommendations, the draft report contained no recommendations.

We did not reproduce the enclosures because they only summarize the report.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

DEC 12 1983

Dear Mr. Anderson:

Thank you for providing us the opportunity to review the GAO draft report titled "Guidelines for Rescuing Large Failing Firms and Municipalities" (Code 971903). We are in the process of considering many of the issues addressed by the draft report, and we appreciate having the benefit of your research in this area.

The GAO report presents a number of guidelines concerning the structure, implementation, and administration of any future financial assistance programs established to rescue particular firms and municipalities. While the report contains no specific recommendations, it discusses the adoption of a formal industrial policy under which a standby Federal entity similar to the Reconstruction Finance Corporation would be established in order to provide such financial assistance. In this connection, you may be interested in the enclosed copy of Secretary Regan's October 14, 1983 speech before the University of Kansas in which he discusses the Administration's reasons for not adopting such an industrial policy.

Sincerely,

Thomas J. Healey
Assistant Secretary
(Domestic Finance)

Mr. William J. Anderson
Director
General Government Division
United States General
Accounting Office
Washington, D.C. 20548

Enclosure

cc: Gary L. Whittington
Assistant Inspector General (TOSCA)

GAO Note: We did not reproduce the Secretary's October 14, 1983, speech.

(971903)

U.S. Government Printing Office 1984